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No. 01-928

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF FRANK A. BRANSON, DECEASED,
MARY M. MARCH, EXECUTOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the Tax Court has jurisdiction to apply the doctrine of equitable recoupment when redetermining an estate tax deficiency, and thereby allow the estate to reduce that deficiency by the amount of a time-barred income tax overpayment.

TABLE OF CONTENTS

	Page
Opinion below	1
Jurisdiction	1
Statutes involved	2
Statement	3
Reasons for granting the petition	10
Conclusion	24
Appendix A	1a
Appendix B	28a
Appendix C	73a
Appendix D	131a

TABLE OF AUTHORITIES

Cases:

Bull v. *United States*, 295 U.S. 247 (1935)	11
Commissioner v. *Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943)	*passim*
Continental Equities, Inc. v. *Commissioner*, 551 F.2d 74 (5th Cir. 1977)	17
Estate of Mueller v. *Commissioner*:	
101 T.C. 551 (1993) rev'd on this issue, 153 F.3d 302 (6th Cir. 1998), cert. denied, 525 U.S. 1140 (1999)	16, 17, 18
107 T.C. 189 (1996)	18
153 F.3d 302 (6th Cir. 1998), cert. denied, 525 U.S. 1140 (1999)	8, 10, 12, 13-14, 16, 17, 18, 20-21
Estate of Sanford Commissioner, 308 U.S. 39 (1939)	21
Estate of Schneider v. *Commissioner*, 93 T.C. 568 (1989)	13, 16
Estate of Van Winkle v. *Commissioner*, 51 T.C. 994 (1969)	16
O'Brien v. *United States*, 766 F.2d 1038 (7th Cir. 1985)	11

Cases—Continued: Page

Phillips Petroleum Co. v. *Commissioner*, 92 T.C. 885 (1989) 16
Rothensies v. *Electric Storage Battery Co.*, 329 U.S. 296 (1946) 5-6, 11
Thor Power Tool Co. v. *Commissioner*, 439 U.S. 522 (1979) 23
United States v. *Calamaro*, 354 U.S. 351 (1957) 22
United States v. *Olympic Radio & Television*, 349 U.S. 232 (1955) 22
Vandenberge v. *Commissioner*, 3 T.C. 321 (1944), aff'd, 147 F.2d 167 (5th Cir.), cert. denied, 325 U.S. 875 (1945) 16

Statutes and regulation:

Internal Revenue of 1939, 26 U.S.C. 272(g) (1940) 14
Internal Revenue Code (26 U.S.C.):
§ 661(a) 4
§ 662(a) 4
§ 1014(a)(1) 4
§ 2031 4
§ 6213(a) 12
§ 6214 2
§ 6214(a) 12
§ 6214(b) 7, 9, 14, 19, 20
§ 6512 3
§ 6512(b) 7, 8, 9
§ 6512(b)(1) 13
§ 7442 11
Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 951-962, 83 Stat. 730-736 17
26 C.F.R. 20.0-2(a) 21

Miscellaneous:

Andrew, *Modern-Day Equitable Recoupment and the "Two Tax Effect:" Avoidance of the Statutes of Limitation in Federal Tax Controversies*, 28 Ariz. L. Rev. 595 (1986) 17

Miscellaneous—Continued: Page

Dubroff, *The United States Tax Court—An Historical Analysis* (1979) 17

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PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-27a) is reported at 264 F.3d 904. The opinions of the United States Tax Court (App., *infra*, 28a-72a, 73a-130a) are reported at 78 T.C.M. (CCH) 78 and 113 T.C. 6.

JURISDICTION

The judgment of the court of appeals was entered on September 5, 2001 (App., *infra*, 1a). On November 20, 2001, Justice O'Connor extended the time within which

to file a petition for a writ of certiorari to January 3, 2002. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

1. Sections 6214 of the Internal Revenue Code, 26 U.S.C. 6214, provides in relevant part:

SEC. 6214. Determinations by Tax Court

(a) *Jurisdiction as to increase of deficiency, additional amounts, or additions to the tax*—Except as provided by section 7463, the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any additional amount, or any addition to the tax should be assessed, if claim therefor is asserted by the Secretary at or before the hearing or a rehearing.

(b) *Jurisdiction over other years and quarters*—The Tax Court in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid.

* * * * *

2. Section 6512 of the Internal Revenue Code, 26 U.S.C. 6512, provides in relevant part:

> SEC. 6512. Limitations in case of petition to Tax Court
>
> * * * * *
>
> (b) *Overpayment determined by Tax Court*—
>
> (1) *Jurisdiction to determine*—Except as provided by paragraph (3) and by section 7463, if the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year, of gift tax for the same calendar year, or calendar quarter, of estate tax in respect of the taxable estate of the same decedent, or of tax imposed by chapter 41, 42, 43, or 44 with respect to any act (or failure to act) to which such petition relates, in respect of which the Secretary determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court has become final, be credited or refunded to the taxpayer.
>
> * * * * *

STATEMENT

1. Frank A. Branson died in November, 1991. His daughter, Mary M. March, is the executrix and residuary legatee of the estate. App., *infra*, 2a. The estate of Mr. Branson owned shares of stock in two closely held corporations. The estate ascribed a date-of-death value

to those shares that had two independent roles in determining taxes owed by the estate: (i) it determined the value assigned to those shares on the estate tax return in computing the gross estate (and the resulting taxable estate) under 26 U.S.C. 2031; and (ii) it determined the basis in the shares for the estate (or the heirs) in determining gain or loss upon any subsequent disposition of the shares under 26 U.S.C. 1014(a)(1). App., *infra*, 3a.

In 1992, the executrix, acting pursuant to court order, sold some of these shares and used the proceeds to pay federal estate taxes and California death taxes totaling approximately $1.2 million. On the estate's income tax return for that year, the estate reported capital gains of $612,300 from the sale of the shares. The estate took a deduction for that amount on its income tax return, however, since it was acting as a fiduciary in selling the stock to pay estate taxes due. See 26 U.S.C. 661(a). As a consequence, Mary March and her husband were therefore required to report (and did report) these capital gains on their joint income tax return for 1992. See 26 U.S.C. 662(a). They filed that return, and paid the taxes due, on or about April 15, 1993. App., *infra*, 3a.

2. Approximately two years later, on March 16, 1995, the Commissioner determined a deficiency of $756,564 in the estate tax liability. That deficiency was based on the Commissioner's determination that the value of the shares on the date of the decedent's death was substantially higher than the estate had reported. The estate petitioned the Tax Court for a redetermination of that estate tax deficiency. App., *infra*, 3a.

If the Commissioner were correct that the stock had a higher value on the date of death than that reported on the estate tax return, a higher basis for the stock

would then also be available for calculating gain on disposition of the stock for income tax purposes. On the date that the notice of deficiency of estate taxes was issued, approximately 13 months remained of the three-year period of limitations for the filing of a refund claim by the Marches for any overpayment of their 1992 personal income tax obligations. The Marches nonetheless failed to file a protective claim for refund of their income taxes for that year. App., *infra*, 4a.

3. On July 13, 1999, the Tax Court found that the value of the shares on the date of the decedent's death was higher than the estate had reported but lower than the Commissioner had calculated. As a result, the court found an estate tax deficiency that was smaller than the Commissioner had determined. App., *infra*, 70a.

These findings could also have supported a claim by the Marches that the estate had understated its basis and overstated its gain on the sale of the stock and that the Marches (to whom the gain had been distributed) consequently had overpaid their income tax for 1992. App., *infra*, 4a. By the date on which the Tax Court entered its opinion, however, the statute of limitations on filing a refund claim by the Marches for the income tax overpayment had long expired. *Ibid.*

The estate nonetheless belatedly asked the Tax Court to credit any income tax overpayment by the Marches for 1992 that might result from the revaluation of stock held by the estate against the estate tax deficiency that would follow from such revaluation. The estate asserted that the doctrine of "equitable recoupment" would support that cross-application of taxes in this context. The Commissioner, however, noted that it has long been held that the Tax Court lacks any jurisdiction to apply the doctrine of equitable recoupment. See, *e.g.*, *Rothensies* v. *Electric Storage Battery Co.*,

329 U.S. 296, 303 (1946); *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418, 420-421 (1943). The Commissioner further argued that the doctrine of equitable recoupment would, in any event, be inapplicable on the facts of this case.

The Tax Court, in a reviewed opinion, concluded that it has jurisdiction to apply the doctrine of equitable recoupment and further held that equitable recoupment applies in the circumstances of this case. App., *infra*, 85a-115a. The court therefore entered a decision determining an estate tax deficiency of $348,016 but allowing a credit against that liability, under the doctrine of equitable recoupment, for an asserted overpayment by the Marches of $96,515 for 1992 income taxes on their joint return. *Id.* at 131a.

4. The court of appeals affirmed. App., *infra*, 1a-27a. The court noted that, in exercising its jurisdiction to redetermine the *estate tax* deficiency in this case, the Tax Court was required to value the closely held stock owned by the estate. The court of appeals also noted that, if this case had been brought as an estate tax refund suit in federal district court, the district court would unquestionably have been able to consider an equitable recoupment claim. The court of appeals concluded that it would be anomalous for a district court to be empowered to grant equitable recoupment in a tax case if the Tax Court could not. The court suggested that such a result would be undesirable because it could potentially prejudice less affluent taxpayers—for a taxpayer who wishes to challenge the Commissioner's determination that additional tax is due without first paying the tax in dispute must do so in Tax Court. *Id.* at 11a-12a.

The court of appeals then addressed whether the applicable statutes require a different conclusion. App.,

infra, 12a-16a. The court noted that Section 6214(b) of the Internal Revenue Code expressly provides that, in redetermining an income or gift tax deficiency, the Tax Court "shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid." 26 U.S.C. 6214(b). The court stated that this provision does not, by its terms, apply in estate tax cases and thus does not, by its terms, preclude the Tax Court from granting equitable recoupment against estate tax liabilities (App., *infra*, 14a):

> We disagree with the Commissioner's assessment of these statutory provisions and find nothing in the cited statutes that prevents the Tax Court from considering the defense of equitable recoupment in this case. First, Section 6214(b), entitled "Jurisdiction over other years and quarters," cannot limit the Tax Court's jurisdiction in this case because Appellee's estate tax deficiency and consequent income tax overpayment were both paid in the same tax year. In addition, § 6214(b), by its terms, applies only when the Tax Court is engaged in a redetermination of an income or gift tax deficiency. It is simply not applicable where, as here, the Tax Court's jurisdiction is invoked to redetermine an estate tax deficiency. We therefore find that § 6214(b) does not bar the application of equitable recoupment in this case.

The court of appeals then addressed Section 6512(b) of the Code. That Section authorizes the Tax Court not only to determine "that there is no deficiency" but also to find "that the taxpayer has made an overpayment of income tax for the same taxable year, of gift tax for the same calendar year, or calendar quarter, [or] of estate

tax in respect of the taxable estate of the same decedent * * * in respect of which the Secretary determined the deficiency" that gave rise to the Tax Court's jurisdiction. 26 U.S.C. 6512(b). The court reasoned that this statute supports the Tax Court's application of equitable recoupment in this case, for it (App., *infra*, 15a):

> gives the Tax Court "jurisdiction to decide the entire gamut of possible issues that [control] the determination of the amount of tax liability for the year in question." *Russell* v. *United States*, 592 F.2d 1069, 1072 (9th Cir. 1979). It is this authority that the Tax Court exercised in the present case. It did not determine that there was an income tax overpayment in a prior period—an undertaking forbidden by § 6214(b). Such a determination was not required because equitable recoupment is, in essence, a defense to the statute of limitations raised as part of the estate tax deficiency proceeding.

The court of appeals disagreed with the contrary reasoning of the Sixth Circuit in *Estate of Mueller* v. *Commissioner*, 153 F.3d 302 (1998), cert. denied, 525 U.S. 1140 (1999), which held that the Tax Court lacks equitable recoupment jurisdiction. The court also suggested (but did not hold) that the decision in *Mueller* was distinguishable because the taxpayer in that case "sought recoupment of an income tax overpayment that was made in a different tax year from the estate tax deficiency before the Tax Court," whereas in this case the income tax to be recouped was paid in the same year as the estate tax was paid. App., *infra*, 16a n.5.

Finally, the court of appeals stated (App., *infra*, 16a) that the decision of this Court in *Commissioner* v.

Gooch Milling & Elevator Co., 320 U.S. 418 (1943), does not govern this case. In *Gooch Milling*, this Court reviewed the predecessors to Sections 6214(b) and 6512(b) and concluded that—because granting equitable recoupment necessarily requires the determination of an underpayment or overpayment of a time-barred tax—the Board of Tax Appeals (which, in 1942, was renamed as the Tax Court) lacked jurisdiction to consider equitable recoupment claims. The court of appeals stated that *Gooch Milling* is distinguishable because it involved an attempt to recoup an income tax overpayment from one period against an income tax deficiency in another, whereas the present case involves the recoupment of an income tax against an estate tax deficiency. The court of appeals stated that this difference is "significant" (App., *infra*, 19a)

> because, as noted above, 26 U.S.C. § 6214(b) only prohibits the Tax Court from determining whether taxes in other years have been overpaid or underpaid. It says nothing about determining overpayments of other taxes from the same year. * * * Moreover, this section of the Code applies only when the Tax Court is determining a deficiency in income or gift taxes. It does not apply in estate tax cases.

The court of appeals therefore concluded that its decision upholding the exercise of equitable recoupment jurisdiction by the Tax Court "is not foreclosed by *Gooch Milling*." App., *infra*, 19a. The court of appeals then affirmed the Tax Court's application of the doctrine of equitable recoupment on the facts of this case. *Id.* at 19a-26a.

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals conflicts with the reasoning and with the conclusion reached by this Court in *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943). It also directly conflicts with the recent decision of the Sixth Circuit in *Estate of Mueller* v. *Commissioner*, 153 F.3d 302 (1998), cert. denied, 525 U.S. 1140 (1999).

The Tax Court, as an Article I court, has a limited jurisdiction prescribed by statute. The question whether that court possesses jurisdiction to grant the non-statutory relief of equitable recoupment is a recurring question of substantial importance to the administration of the tax laws. The direct result of the conflict created by the decision in this case is that taxpayers will be uncertain as to the scope of, and the manner for protecting, their rights in Tax Court cases. Because of the recurring importance of this issue, and its fundamental relationship to the nature of proceedings conducted in Article I courts, resolution of this conflict by this Court is warranted.

1. a. The doctrine of equitable recoupment is a non-statutory principle that has been applied by federal courts in narrow, specified circumstances to relieve certain harsh applications of the statute of limitations that govern tax collection and tax refund claims. It permits both the government and the taxpayer to avoid the effect of statutes of limitations by permitting, in limited circumstances, a time-barred tax overpayment (or a time-barred assessment) to be set off against (or "recouped" against) an *inconsistent* tax liability (or inconsistent defense to such liability) asserted in a timely tax proceeding brought with respect to the *same transaction*. The doctrine of equitable recoupment is

"in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded." *Bull* v. *United States*, 295 U.S. 247, 262 (1935). "Recoupment * * * will permit the government to recoup a correctly assessed tax, which ordinarily could not be collected because of a statute of limitations bar, against a timely refund of a tax erroneously collected and conversely will permit a taxpayer to recoup an erroneously paid tax, the refund of which is time-barred, against a timely and correctly asserted deficiency by the government." *O'Brien* v. *United States*, 766 F.2d 1038, 1049 (7th Cir. 1985). To be eligible for recoupment, the time-barred claim must result from the same transaction that gave rise to the timely refund or deficiency claim. *Rothensies* v. *Electric Storage Battery Co.*, 329 U.S. 296, 299 (1946); *O'Brien* v. *United States*, 766 F.2d at 1049.

b. For equitable recoupment to apply in a taxpayer's favor, it is thus essential that there be a time-barred overpayment of tax to be set off (or "recouped") against the tax liability that is the subject of the timely suit. Since its formation, however, the Tax Court has been and remains a court of limited statutory jurisdiction.[1] Both by the express provisions that grant and limit its jurisdiction, and by the absence of any provision that confers authority for equitable recoupment upon it, the

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[1] The jurisdiction of the Tax Court is described by Section 7442 of the Code, 26 U.S.C. 7442, which specifies that:

> The Tax Court and its divisions shall have such jurisdiction as is conferred on them by this title, by chapters 1, 2, 3, and 4 of the Internal Revenue Code of 1939, by title II and title III of the Revenue Act of 1926 (44 Stat. 10-87), or by laws enacted subsequent to February 26, 1926.

Tax Court has never possessed authority to determine that an overpayment or underpayment exists with respect to any tax or taxable period *other than* the tax or taxable period for which the deficiency was issued that gave rise to the Tax Court petition. Because the Tax Court lacks jurisdiction over taxes or tax periods *outside* the scope of the notice of deficiency that it has authority to review, the Tax Court lacks authority to consider equitable recoupment claims. *Estate of Mueller* v. *Commissioner*, 153 F.3d at 305:

> Taken together, §§ 6214(b) and 6512(b) explicitly confer on the Tax Court jurisdiction to do no more than determine the amount of the deficiency before it. The Tax Court's jurisdiction cannot extend beyond its statutory confines to encompass an equitable remedy such as recoupment * * * .

In the present case, the Tax Court had jurisdiction under Section 6213(a) of the Internal Revenue Code for a "redetermination of the deficiency" issued to the estate for the estate taxes that it owed. 26 U.S.C. 6213(a).[2] By its express terms, that jurisdiction does not encompass any determination of the time-barred income tax refund claim of the Marches for 1992. Because "the statute of limitations had already run to bar the taxpayer's claim for a refund" and because the Tax Court lacked jurisdiction to consider that time-barred overpayment in reviewing the deficiency properly before it, the Tax Court's "want of jurisdiction to

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[2] That jurisdiction authorizes the Tax Court to determine the correct amount of the deficiency (even if it is larger or smaller than the amount initially asserted in the deficiency notice) and to determine whether any statutory additions to the tax should be assessed. 26 U.S.C. 6214(a).

apply the doctrine of equitable recoupment" in this context is "manifest" from the provisions that limit its jurisdiction. *Estate of Mueller* v. *Commissioner*, 153 F.3d at 305 (quoting *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. at 420).

c. The Tax Court has a narrow and specific jurisdiction to determine tax overpayments as well as to redetermine deficiencies under Section 6512(b)(1) of the Code. That jurisdiction is expressly limited to determining overpayments of the specific tax and tax period in respect of which the notice of deficiency was issued. 26 U.S.C. 6512(b)(1). This provision does not confer on the Tax Court jurisdiction to determine an overpayment of a tax that is *not* the subject of a notice of deficiency and a timely petition for redetermination. *Estate of Schneider* v. *Commissioner*, 93 T.C. 568, 570 (1989). In the present case, the Tax Court thus had jurisdiction to determine whether the estate overpaid its estate taxes, for that is the tax in respect of which the Commissioner determined a deficiency. The personal income tax liability of the Marches for 1992, however, was *not* the subject of a deficiency notice or of a timely petition to the Tax Court. Section 6512(b)(1) thus did not confer jurisdiction on the Tax Court to determine whether the Marches overpaid their income tax on the gain from the sale of stock distributed to them by the estate. Because the court had no jurisdiction to determine whether such an overpayment occurred, it had no jurisdiction to apply the doctrine of equitable recoupment in this case. As the Sixth Circuit explained in *Estate of Mueller* v. *Commissioner*, 153 F.3d at 306:

> to apply equitable recoupment, the Tax Court would have to move beyond the scope of the deficiency at

> hand and determine an overpayment of a tax assessment not properly before it. * * * [Sections 6214(b) and 6512(b)] make it clear that such a determination exceeds the limits of the Tax Court's jurisdiction.

2. In *Commissioner* v. *Gooch Milling & Elevator Co.*, 320 U.S. at 420, this Court held more than 50 years ago that the Board of Tax Appeals (the predecessor of the Tax Court) lacked jurisdiction to consider equitable recoupment claims. In reaching that conclusion, this Court applied the indistinguishable predecessors of the statutes that are "now codified as §§ 6214(b) and 6512(b)." *Estate of Mueller* v. *Commissioner*, 153 F.3d at 305. Looking to these predecessor provisions, the Court observed in *Gooch Milling* that the scope of the Board's jurisdiction is "clear and unambiguous" and that "[t]he Board is confined to a determination of the amount of deficiency or overpayment for the particular tax year as to which the Commissioner determines a deficiency and as to which the taxpayer seeks a review of the deficiency assessment." 320 U.S. at 420. Referring specifically to Section 272(g) of the Internal Revenue Code of 1939, which is the predecessor to the current Section 6214(b), the Court held that "[t]he Board's want of jurisdiction to apply the doctrine of equitable recoupment in this case is manifest from these statutory provisions." 320 U.S. at 420. The Court explained (*id.* at 420-421; emphasis added, footnotes omitted):

> The Commissioner assessed a deficiency only for the 1936 fiscal year and it was this assessment of which the respondent sought a review. The Board thus had jurisdiction to do no more than redetermine the 1936 deficiency distinct from any overpayment or

> underpayment in any prior or subsequent year. There was no occasion here for the Board to exercise its power under § 272(g) to consider any facts relating to the taxes for the 1935 fiscal year. The redetermination of the tax liability for the 1936 fiscal year was in no way dependent on any prior tax assessment or overpayment. Likewise, neither the fact that the prior overpayment could no longer be refunded nor the fact that the overpayment exceeded the amount of the deficiency had any relevance whatever to the redetermination of the correct tax for the 1936 fiscal year. *The respondent, in other words, was seeking to have the 1935 overpayment used, not as an aid in redetermining the 1936 deficiency, but as an affirmative defense or offset to that deficiency. This necessarily involved a determination of whether there was an overpayment during the 1935 fiscal year.* The absolute and unequivocal language of the proviso of § 272(g), however, placed such a determination outside the jurisdiction of the Board. Thus to allow the Board to give effect to an equitable defense which of necessity is based upon a determination foreign to the Board's jurisdiction would be contrary to the expressed will of Congress.

Noting that the Board's jurisdiction is controlled by the Internal Revenue Code, not by general equitable principles, the Court concluded that, "[u]ntil Congress deems it advisable to allow the Board to determine the overpayment or underpayment in any taxable year other than the one for which a deficiency has been assessed, the Board must remain impotent when the plea of equitable recoupment is based upon an over-

payment or underpayment in such other year." 320 U.S. at 422.

3. a. As the Sixth Circuit emphasized in *Estate of Mueller* v. *Commissioner*, 153 F.3d at 306:

> Since the *Gooch Milling* decision, federal courts, including the Tax Court itself, have repeatedly cited the case for the proposition that the Tax Court does not have the jurisdiction to consider the affirmative defense of equitable recoupment. See, *e.g.*, *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 303 (1946) (citing Gooch Milling and holding unequivocally that "the Tax Court has no jurisdiction to consider recoupment"); *Mohawk Petroleum Co.* v. *Commissioner of Internal Revenue*, 148 F.2d 957, 959 (9th Cir. 1945) * * * ; *Elbert v. Johnson*, 164 F.2d 421, 424 (2d Cir. 1947) ("[T]he Tax Court lacked power to allow as a credit against the 1938 income tax, by way of recoupment, the gift tax paid in 1936."); *Wiener Machinery Co., Inc. v. Commissioner of Internal Revenue*, 16 T.C. 48, 54 (1951) (citing *Gooch Milling* for the proposition that "[t]his Court lacks the power to apply the doctrine of equitable recoupment"); * * * .

Until its decision in *Estate of Mueller* v. *Commissioner*, 101 T.C. 551 (1993), rev'd on this issue, 153 F.3d 302 (6th Cir. 1998), cert. denied, 525 U.S. 1140 (1999), the Tax Court had consistently held that it lacks jurisdiction to consider equitable recoupment. See, *e.g.*, *Estate of Schneider* v. *Commissioner*, 93 T.C. 568 (1989); *Phillips Petroleum Co.* v. *Commissioner*, 92 T.C. 885 (1989); *Estate of Van Winkle* v. *Commissioner*, 51 T.C. 994, 999-1000 (1969); *Vandenberge* v. *Commissioner*, 3 T.C. 321, 327-328 (1944), aff'd, 147 F.2d 167 (5th Cir.), cert. denied, 325 U.S. 875 (1945). Both courts and

commentators had thus long understood that the Tax Court has no authority to consider claims of equitable recoupment. See Dubroff, *The United States Tax Court—An Historical Analysis* 484-488 (1979); Andrews, *Modern-Day Equitable Recoupment and the "Two Tax Effect:" Avoidance of the Statutes of Limitation in Federal Tax Controversies*, 28 Ariz. L. Rev. 595, 614 (1986).[3]

In *Estate of Mueller* v. *Commissioner*, 101 T.C. at 559-560, however, the Tax Court majority "rebelled against the overwhelming weight of statutory authority and prior case law." 153 F.3d at 306. In that case, as in the present one, the Tax Court determined that the date of death value of stock held by an estate was greater than the value that the estate reported in its estate tax return, and the consequence of that determination was to increase the amount of the estate tax. This increase in the value of the stock meant that the decedent's administration trust had used too low a basis in calculating the gain it realized on its sale of the stock, and had overpaid its income tax with respect to the sale. Although the estate tax deficiency was asserted several months before the limitations period had expired with respect to the income tax liability, the administration trust failed to file a timely protective claim for refund of that overpayment. The Tax Court concluded in *Estate of Mueller*, as it did in this case,

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[3] When the Tax Court was made an Article I "legislative court" by the Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 951-962, 83 Stat. 730-736, the governing statutes were not altered (see *Estate of Mueller* v. *Commissioner*, 153 F.3d at 305-306), and no jurisdiction was conferred on the Tax Court over equitable claims. *Continental Equities, Inc.* v. *Commissioner*, 551 F.2d 74, 82-84 (5th Cir. 1977).

that it had jurisdiction to order equitable recoupment of the administration trust's time-barred income tax overpayment against the estate's liability for estate tax, saying that "neither section 6214(b) or 6512(b) nor *Gooch Milling* denies us authority to apply equitable recoupment." 101 T.C. at 553.[4]

On appeal, the Sixth Circuit held that the Tax Court erred in failing to follow *Gooch Milling* and in concluding that it possesses jurisdiction to apply principles of equitable recoupment. *Estate of Mueller* v. *Commissioner*, 153 F.3d at 307. As described above, the court of appeals held that the statutes governing the jurisdiction of the Tax Court "confirm[] what federal courts have been holding for more than 50 years" — that the Tax Court is empowered only to determine the taxes due with respect to "the deficiency before it" and may not determine (or set off) overpayments of taxes or tax years not encompassed within that deficiency. *Id.* at 305. The Sixth Circuit also emphasized that the Tax Court had committed a serious error by not following the holding of this Court in *Gooch Milling* (*id.* at 306):

> The reasoning in *Gooch Milling* is just as applicable to the determination of estate tax deficiencies as it is to determination of income tax deficiencies. In both situations, in order to apply equitable recoupment, the Tax Court would have to move beyond the scope of the deficiency at hand and determine an overpayment of a tax assessment not

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[4] The Tax Court then held, however, in a separate reviewed opinion, that equitable recoupment was inapplicable in that case because the estate did not owe a deficiency against which recoupment might be had. *Estate of Mueller* v. *Commissioner*, 107 T.C. 189 (1996).

> properly before it. As we explained above, §§ 6214(b) and 6512(b) (formerly §§ 272 and 322(d)) make it clear that such a determination exceeds the limits of the Tax Court's jurisdiction.

b. In the present case, the Ninth Circuit disagreed with the reasoning of the Sixth Circuit in *Estate of Mueller* and held that *Gooch Milling* is distinguishable from, and inapplicable to, this estate tax case. The Ninth Circuit stressed that *Gooch Milling* involved an attempt to recoup a time-barred income tax overpayment against an income tax deficiency, whereas the present case involved an attempt to recoup a time-barred income tax overpayment against an estate tax deficiency. The court stated that this difference is (App., *infra*, 19a)

> significant because * * * 26 U.S.C. § 6214(b) only prohibits the Tax Court from determining whether taxes in other years have been overpaid or underpaid. It says nothing about determining overpayments of other taxes from the same year. * * * Moreover, this section of the Code applies only when the Tax Court is determining a deficiency in income or gift taxes. It does not apply in estate tax cases.

The court of appeals viewed Section 6214(b) as a narrow "prohibit[ion]" on the determination of an underpayment or overpayment of taxes by the Tax Court. Because Section 6214(b) does not, by its terms, apply to estate tax deficiencies, the court reasoned that the asserted "prohib[ition]" of the statute is inapplicable here and that, as a result, the Tax Court is free to grant equitable recoupment with respect to a time-barred income tax overpayment against the liability for estate tax determined in this case.

Contrary to the reasoning of the Ninth Circuit, however, Section 6214(b) is not a prohibitory statute. It is instead a *grant* of authority to the Tax Court to "consider * * * facts" pertaining to taxable periods other than the one for which the deficiency is at issue, but only when doing so is "necessary correctly to redetermine the amount of [the] deficiency" that has properly been brought before that court. 26 U.S.C. 6214(b). That limited authority to consider facts from other taxable periods is granted under Section 6214(b) only when the deficiency to be redetermined by the Tax Court is of income tax or gift tax. *Ibid.* And, even in the narrow context to which it applies, Section 6214(b) confers no authority to determine whether the *tax* for a time-barred taxable period has been overpaid or underpaid.[5] Moreover, because this statute, by its terms, does not apply to determination of deficiencies in estate tax, it obviously does not provide any authority to the Tax Court to apply the doctrine of equitable recoupment in this case. And, no other statute has been, or can be, cited that confers such authority to the Tax Court. As the Sixth Circuit thus correctly held in *Estate of Mueller*, "[t]he statute's failure to mention estate taxes does not support the theory that the Tax Court's jurisdiction is limited in income and gift tax

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[5] Section 6214(b) expressly provides that, although the Tax Court may consider facts from other periods when redetermining a deficiency properly before that court, the court "shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid." 26 U.S.C. 6214(b).

cases, but unlimited in estate tax cases." *Estate of Mueller*, 153 F.3d at 305.[6]

c. The Ninth Circuit made clear its belief that it would be desirable, as a matter of policy, for the Tax Court to have the same authority to grant equitable recoupment that the district courts possess. App., *infra*, 10a-12a. Indeed, the court of appeals' assessment of the policy justifications for allowing equitable recoupment in the Tax Court was so central to its reasoning that the court found it unnecessary to look for a jurisdictional basis for allowing that doctrine to be applied in the Tax Court. Instead, the court of appeals stated that the question that it would address is whether there is "some congressional indication that equitable recoupment is *beyond* the jurisdiction of the Tax Court." *Id.* at 12a (emphasis added).

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[6] The Ninth Circuit also asserted in the present case that the facts of this case differ from *Estate of Mueller* in that the taxpayer in that case sought to recoup a time-barred "income tax overpayment that was made in a different tax year from the estate tax deficiency before the Tax Court." App., *infra*, 16a n.5. The court of appeals made no attempt to explain how (or even whether) this purported factual distinction would have any legal significance. See *ibid.*

In fact, it does not. The estate tax, unlike the income and gift taxes, is not a periodic or annual tax. It is a one-time excise imposed on the transfer of the assets of the decedent on the date of death. See, *e.g.*, *Estate of Sanford* v. *Commissioner*, 308 U.S. 39, 42 (1939); 26 C.F.R. 20.0-2(a). Since the estate tax is not paid for any specific taxable period, the question whether some other tax happened to be remitted in the same year that the estate tax was remitted has no plausible bearing on the application of the doctrine of equitable recoupment.

The court's *presumption* that such jurisdiction exists, and its search only for a *denial* of that jurisdiction in the provisions of the Code, is, of course, an unwarranted reversal of ordinary jurisdictional principles. That unwarranted presumption of jurisdiction based on the court's perception of desirable policy is particularly inappropriate when considering the inherently limited authority possessed by an Article I tribunal such as the Tax Court.

This Court has long made clear that any assessment of policy justifications for allowing equitable recoupment in Tax Court cases falls within the province of Congress and not of the courts. In *Gooch Milling*, this Court emphasized this very point in stating that, "*[u]ntil Congress deems it advisable* to allow the Board [of Tax Appeals] to determine the overpayment or underpayment in any taxable year other than the one for which a deficiency has been assessed, *the Board must remain impotent* when the plea of equitable recoupment is based upon an overpayment or underpayment in such other year." 320 U.S. at 422 (emphasis added). See also *United States* v. *Calamaro*, 354 U.S. 351, 357 (1957) ("Neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon."); *United States* v. *Olympic Radio & Television, Inc.*, 349 U.S. 232, 236 (1955) (if "changes in the law are desirable," then "Congress must make them").

The policy concerns that influenced the decision of the Ninth Circuit in this case should thus be addressed to Congress, not to the courts. Moreover, in the 58 years since the decision in *Gooch Milling* was announced, Congress has *not* "deem[ed] it advisable" to

amend the jurisdiction provisions of the Tax Court to authorize a "plea of equitable recoupment" to be heard in that court. The court of appeals thus improperly usurped the legislative function in ruling to the contrary in this case.

4. The scope of the Tax Court's authority to grant relief in tax cases is a matter of recurring and fundamental importance to the administration of the tax law. The conflict among the circuits resulting from the decision in this case makes it uncertain whether a taxpayer may obtain equitable recoupment of a time-barred refund claim (or the United States may obtain equitable recoupment of a time-barred assessment) in a proceeding in Tax Court or must, instead, initiate suit in district court. The application of different rules in different circuits on this basic, recurring issue will cause different treatment of otherwise similarly situated taxpayers based solely upon the happenstance of their geographical location. Review of the conflict created by the decision in this case is warranted by the overriding importance, in a national system of taxation, of "ensur[ing] as far as possible that similarly situated taxpayers pay the same tax." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 544 (1979).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 00-70293
Tax Court No. 10028-95

ESTATE OF FRANK BRANSON, DECEASED; MARY M. MARCH, EXECUTOR, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

[Argued and Submitted
July 10, 2001—San Francisco, California
Filed: Sept. 5, 2001]

Before: JOSEPH T. SNEED, KIM MCLANE WARDLAW, and MARSHA S. BERZON, Circuit Judges.

OPINION

SNEED, Circuit Judge:

This case is before us on appeal from a judgment of the Tax Court. In the proceeding below, the Tax Court held that Appellee, the Estate of Frank Branson, had underpaid its estate taxes and owed a deficiency of $348,016. The Tax Court further held that Appellee need not pay the full amount of the deficiency. Rather, the Estate could, under the doctrine of equitable recoupment, credit a $96,515 income tax overpayment

against the estate tax deficiency and pay only the remainder.

The Commissioner of Internal Revenue ("Commissioner") appeals the Tax Court's application of equitable recoupment to reduce the estate tax deficiency. The Commissioner argues, first, that the Tax Court has no jurisdiction to apply equitable recoupment. In the alternative, the Commissioner contends that equitable recoupment is not available on the facts of this case.

We hold that the Tax Court did not exceed its limited jurisdictional grant when it considered the affirmative defense of equitable recoupment. We also affirm the Tax Court's application of that doctrine in this case.

FACTS

Frank Branson ("Decedent") died in November 1991. His daughter, Mary M. March, was named the executor and residuary beneficiary of his estate. As such, she assumed full individual liability for any additional taxes owed by the estate.

The estate contained stock in two separate closely held corporations ("Willits Stock" and "Savings Stock"). On the estate tax return, filed in 1992, the Willits stock was valued at $485 per share and the Savings stock at $181.50 per share. The executor was authorized to sell a certain portion of this stock (500 shares of Willits stock and 2800 shares of Savings stock) in order to pay applicable estate taxes. The Willits Stock sold for $850 per share and the Savings Stock sold for $335 per share, considerably higher than their reported value.

Under 26 U.S.C. § 1014(a)(1), the declared value of the stock was used as a basis for determining the gain

from their sale.[1] Consistent with this statutory requirement, the difference between the stock's reported value and its sale value (approximately $600,000) was reported as a capital gain on the estate tax return. The estate did not pay taxes on this gain, but rather distributed it immediately to March, the residuary beneficiary. March then declared this money as a capital gain on her 1992 income tax return. Under § 1014, March was also required to use the stock value declared on the estate tax return for the purpose of determining her capital gain from the sale. Consequently, she declared a capital gain of approximately $600,000, and paid the taxes due.

In 1995, the Commissioner determined a deficiency on Appellee's estate tax return. The basis of this deficiency was the Commissioner's conclusion that the Willits and Savings stocks were worth substantially more than the estate declared. After Appellee contested the Commissioner's notice of deficiency, the Tax Court concluded that the Willits Stock was worth $626 per share and the Savings Stock was worth $276 per share. The revaluation of the stock led to an estate tax deficiency. Since, pursuant to § 1014, the same valuation was used to determine March's 1992 income tax liability, it necessarily followed that March had overpaid her income taxes in 1992.[2]

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[1] 26 U.S.C. § 1014(a)(1) provides that "the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passes from a decedent shall . . . be the fair market value of the property at the date of the decedent's death."

[2] The capital gain reported on March's income tax was determined by subtracting the declared value of the stock sold by the estate ($750,700) from the value realized through sale ($1,363,000) for a capital gain of approximately $600,000. If the actual value is

Both the Commissioner and the Estate agree that the revaluation of the estate's stock led to both an estate tax deficiency and an income tax overpayment in the 1992 tax year. The ultimate determination of the existence and amount of the estate tax deficiency was decided by the Tax Court in July 1999, long after the statute of limitations had run on a claim for refund of the income tax overpayment. However, the initial notice of estate tax deficiency was issued in March 1995, over a year before the statute of limitations for a refund of the overpaid income tax had run.

March, however, failed to file a refund claim for her 1992 income tax overpayment within the applicable limitations period. Instead, she asked that her income tax overpayment be credited against the estate tax deficiency adjudicated in the Tax Court. The Tax Court agreed and this appeal followed.

I

Standard of Review

Whether the Tax Court has authority to apply the doctrine of equitable recoupment is a jurisdictional determination subject to de novo review. *I & O Pub. Co. Inc. v. Comm'r*, 131 F.3d 1314, 1315 (9th Cir. 1997); *Estate of Mueller v. Comm'r*, 153 F.3d 302, 304 (6th Cir. 1998). The Tax Court's application of the law to undisputed facts is reviewed de novo. *Pac. First Fed. Sav. Bank v. Comm'r*, 961 F.2d 800, 803 (9th Cir. 1992).

II

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higher than that declared, the capital gain is, consequently, lower —resulting in an overpayment of income tax.

Jurisdiction

In deciding whether the Tax Court has jurisdiction to apply the doctrine of equitable recoupment in this circumstance, we start by stating certain principles that are well-established and not in dispute. First, the Tax Court, like any federal court, is a court of limited jurisdiction. "Federal courts . . . possess only that power authorized by Constitution and statute." *Kokkonen v. Guardian Life Ins. Co. of Am.*, 511 U.S. 375, 377, 114 S. Ct. 1673, 128 L. Ed. 2d 391 (1994). The statute conferring subject matter jurisdiction on the Tax Court is Title 26 of the United States Code. 26 U.S.C. § 7442. The Tax Court's jurisdiction is defined and limited by Title 26 and it may not use general equitable powers to expand its jurisdictional grant beyond this limited Congressional authorization. It may exercise its authority only within its statutorily defined sphere. *Comm'r v. McCoy*, 484 U.S. 3, 7, 108 S. Ct. 217, 98 L. Ed. 2d 2 (1987) (Tax Court "lacks general equitable powers"); *Kelley v. Comm'r*, 45 F.3d 348, 351 (9th Cir. 1995) (Tax Court is an "Article I court designed to handle cases of a specialized nature").

Within that sphere, however, "the Tax Court exercises its judicial power in much the same way as the federal district courts exercise theirs." *Freytag v. Comm'r*, 501 U.S. 868, 891, 111 S. Ct. 2631, 115 L. Ed. 2d 764 (1991). This includes the authority to apply the full range of equitable principles generally granted to courts that possess judicial powers. "Even if the Tax Court does not have far-reaching general equitable powers, it can apply equitable principles and exercise equitable powers within its own jurisdictional competence." *Estate of Ashman v. Comm'r*, 231 F.3d 541, 545 (9th Cir. 2000); *See also Kelley*, 45 F.3d at 352 (Tax

Court has equitable power to reform agreements between taxpayer and IRS); *Buchine v. Comm'r*, 20 F.3d 173, 178 (5th Cir. 1994) (holding that the Tax Court had the authority to apply the "equitable principle of reformation to a case over which it had jurisdiction").

Having set forth that which is not in dispute, we come to the issue at the heart of this appeal. Does the Tax Court's statutory grant of authority prevent it from applying the equitable doctrine of recoupment when redetermining an estate tax deficiency? We find the answer to be "no." Consequently, we hold that where, as here, the Tax Court has jurisdiction to redetermine an estate tax deficiency, it may exercise its equitable powers to recoup an income tax overpayment from the same tax year if all the criteria for an equitable recoupment claim are otherwise satisfied.

We first proceed to a brief description of the principles and purposes underlying the doctrine of equitable recoupment. We then examine the statutory authority delimiting the Tax Court's jurisdiction. Finding no conflict between the two, we affirm the Tax Court's exercise of jurisdiction and proceed to determine whether recoupment was properly granted on the facts of this case.

A. *Equitable Recoupment*

Generally, a party who has paid a tax that was not owed may sue for a refund under 26 U.S.C. § 6511. Refund suits, however, are subject to a strict statute of limitations. 26 U.S.C. § 6511(b)(1); § 6512(b)(3) (no credit or refund is allowed if taxpayer fails to file a refund claim or seek a redetermination in Tax Court within three years of when return was filed); *See also, Comm'r v. Lundy*, 516 U.S. 235, 240, 116 S. Ct. 647, 133

L. Ed. 2d 611 (1996). In some circumstances, a taxpayer may be time barred from seeking a refund of an erroneous tax, but the IRS can still bring a timely suit for payment of the correct tax. In this limited circumstance, the doctrine of "equitable recoupment" may be raised as a defense to the statute of limitations. It is designed to protect a party from paying twice on a single obligation. *Bull v. United States*, 295 U.S. 247, 258, 55 S. Ct. 695, 79 L. Ed. 1421 (1935).

Equitable recoupment arises when a single "transaction, item or taxable event" is subject to two inconsistent taxes. *United States v. Dalm*, 494 U.S. 596, 608 n. 5, 110 S. Ct. 1361, 108 L. Ed. 2d 548 (1990); *Boyle v. United States*, 355 F.2d 233, 236 (3rd Cir. 1965). The doctrine permits a party to a tax dispute to raise a time barred claim in order to reduce or eliminate the money owed on the timely claim. *Rothensies v. Elec. Storage Battery Co.*, 329 U.S. 296, 300, 67 S. Ct. 271, 91 L. Ed. 296 (1946) ("amount of [the] tax collected on the wrong theory should be allowed in recoupment against an assessment on the correct theory"). Equitable recoupment cannot be used offensively to seek a money payment, only defensively to offset an adjudicated deficiency. *Dalm*, 494 U.S. at 611, 110 S. Ct. 1361.

Because equitable recoupment has the potential to completely override the statute of limitations, the party raising an equitable recoupment claim must satisfy several criteria. First, the same "transaction, item or taxable event" must be subject to two taxes. Second, the taxes must be inconsistent in that the Tax Code authorizes only a single tax. *See Bull*, 295 U.S. at 256, 55 S. Ct. 695 (same funds cannot be taxed both as an asset of the estate and income to the estate); *Dalm*, 494 U.S. at 596, 110 S. Ct. 1361 (single item cannot be

subject to both gift tax and income tax). Third, the tax sought to be recouped must be time barred. *Stone v. White*, 301 U.S. 532, 538, 57 S. Ct. 851, 81 L. Ed. 1265 (1937); *Kolom v. United States*, 791 F.2d 762, 767 (9th Cir. 1986) (*overruled on other grounds*, *Dalm*, 494 U.S. 596, 110 S. Ct. 1361, 108 L. Ed. 2d 548 (1990)). Fourth, there must be an "identity of interest" between the parties paying the duplicative tax. *Stone*, 301 U.S. 532, 57 S. Ct. 851, 81 L. Ed. 1265 (trustee who paid erroneous tax has sufficient identity of interest with beneficiary who owed tax deficiency).

Finally, the court in which the recoupment claim is brought must independently have jurisdiction to adjudicate the claim. Equitable recoupment cannot be the "sole basis of jurisdiction." *Dalm*, 494 U.S. at 608, 110 S. Ct. 1361. It is to this last requirement that we must turn first. *Steel Co. v. Citizens for a Better Environment*, 523 U.S. 83, 94, 118 S. Ct. 1003, 140 L. Ed. 2d 210 (1998) ("On every writ of error or appeal, the first and fundamental question is that of jurisdiction, first, of this court, and then of the court from which the record comes. This question the court is bound to ask and answer for itself. . . .") (quoting *Great Southern Fire Proof Hotel Co. v. Jones*, 177 U.S. 449, 453, 20 S. Ct. 690, 44 L. Ed. 842 (1900)).

B. *Tax Court Jurisdiction*

In the present case, the Tax Court had jurisdiction to determine the estate tax deficiency. Its jurisdiction was invoked in the usual way contemplated by the Tax Code. First, the taxpayer estimated the value of closely held stock owned by the estate. This estimated value was included in the corpus of the estate and estate taxes were calculated based on the total value of

the estate. A portion of the stock was then sold and the proceeds were used to pay taxes. The difference between the estimated value and the sale value of the stock was declared as a capital gain and distributed to March, the residuary beneficiary. The Commissioner, upon examination of the estate tax return, determined a deficiency and sent notice of such to the taxpayer pursuant to 26 U.S.C. § 6212. The taxpayer timely petitioned for redetermination of that deficiency in the Tax Court under 26 U.S.C. § 6213. Jurisdiction over the estate tax deficiency was therefore proper.

In redetermining the estate tax deficiency over which it had jurisdiction, the Tax Court was required to value the closed corporation stocks held by the estate. The valuation of those stocks affected not only the tax liability of the estate, but also the tax liability of the estate's beneficiary to whom the gain from the stock sale was distributed. The Tax Court's single determination that the stocks were undervalued led inexorably to the conclusion that Appellee had both underpaid its estate taxes and overpaid its income taxes. The two taxes were inextricably intertwined because they were both based on the valuation of the same asset—the Willits and Savings stock.

The estate, consequently, raised the undisputed fact of the income tax overpayment as an affirmative defense to the finding of an estate tax deficiency. The Tax Court, having original jurisdiction to redetermine the estate tax deficiency, concluded that it also had jurisdiction to give effect to this affirmative defense and reduce the judgment accordingly. The Tax Court viewed its actions as only "considering such facts with relation to the share value included in both corpus and income so that this item may be examined in all its

aspects, as is necessary to correctly redetermine the amount of the estate tax deficiency now before us." *See Naftel v. Comm'r*, 85 T.C. 527, 533, 1985 WL 15396 (1985) (jurisdiction to determine a deficiency "extends to the entire subject matter of the correct tax for the taxable year"); *Bartels v. Comm'r*, 106 T.C. 430, 435, 1996 WL 310360 (1996) (deficiency jurisdiction confers authority to consider defense of recoupment).

If this case had arisen in the district court, which shares with the Tax Court jurisdiction over federal tax cases, there is no question that Appellee could have raised the defense of equitable recoupment to reduce the estate tax deficiency. *Dalm*, 494 U.S. at 610, 110 S. Ct. 1361 (equitable recoupment defense may be raised in timely refund suit); *Parker v. United States*, 110 F.3d 678 (9th Cir. 1997) (considering merits of equitable recoupment defense raised in the district court).

As noted above, the Tax Court, within its specialized jurisdiction, "operates pretty indistinguishably from a federal district court." *Flight Attendants Against UAL Offset (FAAUO) v. Comm'r*, 165 F.3d 572, 578 (7th Cir. 1999) (citing *Freytag, supra*, at 891, 111 S. Ct. 2631). The Commissioner argues, however, that the presumed equivalence in the authority of the two courts does not apply in this circumstance. To rebut this presumption, however, the Commissioner must find specific support in the provisions of the Tax Code, for we are in agreement with the Seventh Circuit that "the overlap between the district courts' jurisdiction over refund suits and the Tax Court's jurisdiction over deficiency suits . . . makes it anomalous and confusing to multiply distinctions between the doctrines applied by the two types of court." *FAAUO*, 165 F.3d at 578.

More than simply "anomalous," such a distinction would, in practice, work substantial prejudice against less affluent taxpayers. This is so because, although a taxpayer has a choice of fora in which he or she may dispute a notice of deficiency, only in the Tax Court may the taxpayer contest the Commissioner's determination without first paying the amount in dispute. *Flora v. United States*, 362 U.S. 145, 175, 80 S. Ct. 630, 4 L. Ed. 2d 623 (1960) (taxpayers must pay assessment before bringing refund suit in district court, but may "appeal the deficiency to the Tax Court without paying a cent"). For this reason, the Tax Court is the preferred forum for taxpayers who dispute a tax assessment. The Tax Code, moreover, encourages the concentration of tax disputes in the Tax Court, rather than the district court, by offering finality to litigants who elect to bring their claims in this specialized forum. *Woods v. Comm'r*, 92 T.C. 776, 788-789, 1989 WL 32907 (1989) ("The combined effect of [26 U.S.C. §§ 7422(e), 6512(a), and 7481] is to channel tax litigation in the Tax Court, to make our decisions binding, and to preclude relitigation of the same issues in another forum.").

A limitation on the equitable doctrines available in the Tax Court would undermine both the taxpayer's ability to choose to litigate in the Tax Court and the government's effort to channel litigation into this forum. In *Bokum v. Comm'r*, 992 F.2d 1136 (11th Cir. 1993), the Eleventh Circuit refused to impose such a limit on the Tax Court's jurisdiction. In rejecting the Commissioner's contention that the Tax Court lacks

jurisdiction to entertain a defense based on equitable estoppel, that court held:

> If the Tax Court lacked authority to entertain a claim of equitable estoppel, taxpayers with such a claim would no longer have a choice of fora for their tax issues. They would effectively be forced to pay their taxes and sue for a refund, submitting all of their claims to the district courts. . . . Thus, taxpayers would essentially be denied the right to challenge deficiencies in the Tax Court if they wanted to assert an equitable estoppel claim. This would be an unfair choice to pose to taxpayers, and would undermine the purpose of the Tax Court. We therefore conclude that the Tax Court did have jurisdiction over the Bokums' equitable estoppel claim.

Bokum, 992 F.2d at 1140-1141. The same "unfair choice" results from restricting the Tax Court's jurisdiction over equitable recoupment claims.

We recognize, of course, that neither anomalous nor unfair results can negate express statutory directives. *Lundy*, 516 U.S. at 252, 116 S. Ct. 647 (distinction between rules that apply in Tax Court as opposed to district court are compelled by statutory language). Particularly where the Tax Code is at issue, it is the dictates of statute, not of conscience that must control. "There exists no statute or principle in tax law that requires either, for example, a 'decennial' or 'lifetime' adjustment of taxes requiring either refunds or additional taxes as a result of a harmonious and consistent application of taxes throughout the selected time frame." *Harrah v. United States*, 77 F.3d 1122, 1125 (9th Cir. 1995). We turn, therefore, to the Tax Code in

search of some congressional indication that equitable recoupment is beyond the jurisdiction of the Tax Court. We find none.

1. *Statutory Provisions*

For the proposition that the Tax Court lacks jurisdiction to consider an equitable recoupment defense, the Commissioner directs us to Sections 6214(b)[3] and 6512(b)[4] of the Tax Code. The Commissioner argues

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[3] 26 U.S.C. § 6214 Determination by the Tax Court

(b) Jurisdiction over other years and quarters. The Tax Court in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid.

[4] 26 U.S.C. § 6512 **Limitations in case of petition to Tax Court**

(b) Overpayment determined by Tax Court.

(1) Jurisdiction to determine. . . . [I]f the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year, of gift tax for the same calendar year or calendar quarter, of estate tax in respect of the taxable estate of the same decedent, or of tax imposed by chapter 41, 42, 43, or 44 with respect to any act (or failure to act) to which such petition relates, in respect of which the Secretary determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court has

that, taken together, these sections "explicitly confer on the Tax Court jurisdiction to do no more than determine the amount of the deficiency before it." *Mueller v. Comm'r*, 153 F.3d at 305.

In carrying out this function, the Commissioner argues, the Tax Court may not determine a deficiency or overpayment for any tax not presented by an IRS notice of deficiency and disputed by the taxpayer. Because an equitable recoupment defense inherently requires the Tax Court to determine that the time-barred tax was overpaid, §§ 6214(b) and 6512(b) put equitable recoupment beyond the jurisdiction of the Tax Court.

We disagree with the Commissioner's assessment of these statutory provisions and find nothing in the cited statutes that prevents the Tax Court from considering the defense of equitable recoupment in this case. First, Section 6214(b), entitled "Jurisdiction over other years and quarters," cannot limit the Tax Court's jurisdiction in this case because Appellee's estate tax deficiency and consequent income tax overpayment were both paid in the same tax year. In addition, § 6214(b), by its terms, applies only when the Tax Court is engaged in a redetermination of an income or gift tax deficiency. It is simply not applicable where, as here, the Tax Court's jurisdiction is invoked to redetermine an estate tax deficiency. We therefore find that § 6214(b) does not bar the application of equitable recoupment in this case.

Nor does Section 6512(b) prevent the Tax Court from using Appellee's income tax overpayment to reduce its estate tax deficiency. That section of the Code provides

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become final, be credited or refunded to the taxpayer.

that when the Tax Court has jurisdiction to determine a deficiency, it also has jurisdiction to determine an "overpayment of income tax for the same taxable year" and order that any overpayment be "credited or refunded to the taxpayer." 26 U.S.C. § 6512(b)(1). In other words, where the jurisdiction of the Tax Court is properly invoked (as it was here), Section 6512(b) gives the Tax Court exclusive jurisdiction to determine not only whether the "deficiency was correct, but also whether a taxpayer's claim that he has overpaid is correct." *Naftel*, 85 T.C. at 531.

We have previously observed that § 6512(b) (read together with the exclusivity provisions of the code, *See* 26 U.S.C. 7422(e)) gives the Tax Court "jurisdiction to decide the entire gamut of possible issues that [control] the determination of the amount of tax liability for the year in question." *Russell v. United States*, 592 F.2d 1069, 1072 (9th Cir. 1979). It is this authority that the Tax Court exercised in the present case. It did not determine that there was an income tax overpayment in a prior period—an undertaking forbidden by § 6214(b). Such a determination was not required because equitable recoupment is, in essence, a defense to the statute of limitations raised as part of the estate tax deficiency proceeding. *See Bull*, 295 U.S. at 262, 55 S.Ct. 695 ("[R]ecoupment is in the nature of a defense. . . . Such a defense is never barred by the statute of limitations so long as the main action itself is timely.").

After an examination of the relevant sections of the Tax Code, "[w]e are given no reason to suppose that statutes of limitations are intended to be administered differently in the Tax Court than in the federal district courts. . . ." *FAAUO*, 165 F.3d at 578. The Tax Court therefore had jurisdiction to examine the estate tax de-

ficiency "in all its aspects" so as to correctly redetermine the amount of the deficiency for the 1992 tax year. *Rothensies v. Elec. Storage Battery Co.*, 329 U.S. at 299.[5]

2. *Gooch Milling*

We also reject the Commissioner's contention that our reading of the Tax Code is foreclosed by the Supreme Court's decision in *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418, 64 S. Ct. 184, 88 L. Ed. 139 (1943). In *Gooch Milling*, an audit of respondent company's books revealed an erroneous valuation of its inventory. Because of this error, respondent had overpaid its income taxes for 1935. The same erroneous valuation of the same inventory led the Commissioner

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[5] Our reading of the relevant jurisdictional statutes differs somewhat from the Sixth Circuit's reading of the same provisions. In *Estate of Mueller v. Comm'r*, *supra*, the Sixth Circuit held that the Tax Court does not have jurisdiction to consider a taxpayer's equitable recoupment claim. That court read §§ 6214(b) and 6512(b) as restricting the Tax Court's jurisdiction to recoup an overpayment to situations where "the overpayment concerns the same kind of tax and, as to income and gift taxes, only if it was paid in the same year." *Mueller*, 153 F.3d at 305. Thus, because the taxpayer in *Mueller* (like the taxpayer here) sought recoupment of an income tax overpayment from an estate tax deficiency, the Sixth Circuit held that the Tax Court was without jurisdiction to consider this claim.

We also note, however, that in *Mueller* the taxpayer sought recoupment of an income tax overpayment that was made in a different tax year from the estate tax deficiency before the Tax Court. *Id.* at 302 (redetermination of value of stock created an overpayment "in a previous year"). We have no occasion to pass upon the question whether the Tax Court would have jurisdiction to consider an equitable recoupment claim where the tax sought to be recouped was from a previous tax year.

to determine that Gooch Milling had also underpaid its taxes for 1936.[6] Respondent was barred by the statute of limitations from seeking a refund of its overpayment. The Commissioner, however, was not barred from issuing a notice of deficiency for the 1936 underpayment. Respondent appealed this notice to the Board of Tax Appeals (the precursor of the Tax Court), arguing that the 1935 overpayment should be "applied as an offset or recoupment against the 1936 deficiency." *Gooch Milling*, 320 U.S. at 419, 64 S. Ct. 184.

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[6] In *Gooch Milling*, the taxpayer had originally reported a net loss for the 1936 tax year. However, when the Commissioner adjusted the value of the company's 1936 opening inventory (by reducing its value by $237,104.33), respondent showed a net income of $93,828.83 with a tax liability of $14,951.85. *Gooch Milling & Elevator Co. v. Comm'r*, 133 F.2d 131, 133 (8th Cir. 1943) (*overruled on other grounds Gooch Milling & Elevator Co.*, 320 U.S. 418, 64 S. Ct. 184, 88 L. Ed. 139 (1943)).

This adjustment in the valuation of the inventory also affected respondent's 1935 tax liability because Gooch Milling's 1936 opening inventory was identical to its 1935 closing inventory. "The inventory serves a double purpose. It fixes stock on hand at the end of one fiscal year and at the same time determines the same fact for the beginning of the ensuing year." *Id.* at 135. The valuations of the two should have been the same.

Applying the $237,104.33 reduction to the 1935 closing inventory would have resulted in a reduced income for the 1935 tax year and a consequent reduction in Gooch Milling's 1935 tax burden. Because Gooch Milling had already paid its 1935 taxes based on the erroneous inventory valuation (and, consequently, based on an inflated income determination), it had overpaid its income taxes for that year. "The adjustment of the beginning inventory for the 1936 taxable year automatically changed the 1935 closing inventory and established the error in the basis for computing the 1935 tax." *Id.* at 134; *Id.* at 135 ("The same fact that established a deficiency for the fiscal year 1936 establishes an overpayment for the fiscal year 1935. . . .").

The Court held that the Board of Tax Appeals had no jurisdiction to credit the 1935 overpayment against the 1936 deficiency. In reaching this conclusion, the Court relied primarily on Section 272(g) of the Internal Revenue Code of 1939 (later amended and redesignated as Section 6214(b) of the present Code). The Court held that the legislative grant of jurisdiction presently codified in Section 6214(b) "confined [the Board] to a determination of the amount of deficiency or overpayment for the particular tax year as to which the Commissioner determines a deficiency and as to which the taxpayer seeks a review of the deficiency assessment." *Id.* That section specifically prohibited the Board from determining whether a tax for a previous tax year had been overpaid. Because Respondent's equitable recoupment defense "necessarily involved a determination of whether there was an overpayment during the 1935 fiscal year," the Board was without jurisdiction to give effect to this defense. *Id.*

The Commissioner argues that *Gooch Milling* stands for the broad proposition that the Tax Court is without jurisdiction to apply the doctrine of equitable recoupment. Just as the Board of Tax Appeals could not offset a 1935 overpayment against a 1936 deficiency in *Gooch Milling*, the Commissioner argues that the Tax Court may not offset March's income tax overpayment against a separate estate tax deficiency.

Gooch Milling is distinguishable from the present appeal for several reasons. First, *Gooch Milling* involved an appeal from the Board of Tax Appeals, an administrative agency of the executive branch, rather than the Tax Court, an Article I court. The Tax Court's authority to apply equitable doctrines, *see supra*, differentiates it "from its predecessor, the Board of Tax

Appeals, which was held not to be a court and to have no equitable powers." *Toscano v. Comm'r*, 441 F.2d 930, 933 (9th Cir. 1971). Of more importance is that the facts of *Gooch Milling* differ from those in this case. In *Gooch Milling*, the taxpayer sought to recoup a prior year's income tax overpayment against a separate income tax deficiency. In this case, the taxpayer seeks to apply an income tax overpayment against an estate tax deficiency, both of which occurred in the same year.

These differences are significant because, as noted above, 26 U.S.C. § 6214(b) only prohibits the Tax Court from determining whether taxes in other years have been overpaid or underpaid. It says nothing about determining overpayments of other taxes from the same year. "A careful reading of the *Gooch Milling* opinion, and of the relevant statute . . . show[s] that it actually considered only the question of recoupment based on an overpayment in a year other than the year in dispute." *Dalm*, 494 U.S. at 615 n.3, 110 S. Ct. 1361 (Stevens, J. dissenting). Moreover, this section of the Code applies only when the Tax Court is determining a deficiency in income or gift taxes. It does not apply in estate tax cases. Our holding today, affirming the Tax Court's exercise of equitable recoupment jurisdiction in this case, is not foreclosed by *Gooch Milling*.

III

Recoupment

Having concluded that the Tax Court had jurisdiction to consider an equitable recoupment defense, we must also determine whether the Tax Court erred in using March's income tax overpayment to satisfy the estate tax deficiency in this case. As noted above, a party raising an equitable recoupment defense must satisfy

four criteria.[7] In the present case, the Commissioner concedes that refund of the income tax overpayment is time-barred, and, further concedes that there is an identity of interest between the estate's beneficiary and the estate subject to the estate tax deficiency. The Commissioner argues, however, that the two taxes do not satisfy the "same transaction" test and, therefore, were not treated inconsistently under the Code.

We hold that the Tax Court properly applied the doctrine in this case.

A. *Same "transaction, item or taxable event"*

In arguing that the estate tax and income tax at issue in this appeal were not a single transaction, the Commissioner relies on *Rothensies v. Elec. Storage Battery Co.*, 329 U.S. 296, 67 S. Ct. 271, 91 L. Ed. 296 (1946). In *Rothensies*, the Supreme Court refused to allow recoupment of overpaid excise taxes to satisfy an income tax deficiency. In that case, the excise taxes had been paid over 20 years earlier and their recovery had been barred by the statute of limitations for 16 years. The length of time between the overpaid and underpaid taxes in Rothensies illustrated how recoupment of separate overpayments from an income tax deficiency could result in reviving overpayment claims many years after the limitations period had expired. *Id.* at 302, 67 S. Ct. 271. The Court refused to expand the equitable recoupment doctrine in this manner. It

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[7] *See supra* Section III(A). Equitable recoupment arises when 1) the same "transaction, item or taxable event" is subject to two taxes; 2) the taxes are inconsistent; 3) refund of the erroneous tax is time-barred and; 4) there is an "identity of interest" between the party who paid the erroneous tax and the party seeking recoupment.

reaffirmed that recoupment was permissible only when a "single transaction" constituted the taxable event claimed upon and the one considered in recoupment and held that the excise tax overpayments and the income tax deficiency at issue in *Rothensies* did not satisfy this standard. *Rothensies*, 329 U.S. at 299, 67 S. Ct. 271.

Subsequent to *Rothensies*, the Fourth Circuit decided *United States v. Herring*, 240 F.2d 225 (4th Cir. 1957) and this court decided *United States v. Bowcut*, 287 F.2d 654 (9th Cir. 1961). In *Herring*, the Fourth Circuit allowed recoupment of a barred estate tax overpayment against a pre-death income tax deficiency of the decedent. The government's argument was that recoupment was not allowable because, rather than a single transaction, two distinct taxes involving distinct taxable events were involved: an income tax deficiency incurred by the decedent prior to his death and a separate estate tax overpayment paid by the estate within nine months of the decedent's death. However, there was an interrelationship between the two taxes. The deficiency in the pre-death income tax reduced the size of the estate and, consequently, diminished the amount owed in estate taxes. This interrelationship led the court to hold that the overpayment and deficiency were a "single transaction" for the purpose of applying equitable recoupment. "The Government has asserted two claims against the monies of estate that came into the hands of the administratrix . . . and it is impossible to determine the amount of the latter without making due allowance for the deduction caused by the former." *Herring*, 240 F.2d at 228.

In *Bowcut*, we affirmed the district court's grant of equitable recoupment in circumstances identical to those faced by the Fourth Circuit in *Herring*. Our

decision in *Bowcut* did not directly address whether the two taxes satisfied the single transaction test, but we did note that the taxpayer was "seeking to recover the overassessment of estate tax by recoupment from the very fund which, taken from the estate, had brought about the fact of overassessment." *Bowcut*, 287 F.2d at 656. Thus, although we were not "called upon to discuss or pass judgment on [the] question" whether the two taxes constituted a single transaction, we affirmed the district court, which had rejected the government's argument that the single transaction test was not met. *Bowcut*, 287 F.2d at 657 n.1.[8]

The Commissioner understandably argues that *Herring* and *Bowcut* "represent the outer limit to which the 'single transaction' prerequisite for equitable recoupment can be stretched."[9] But the holdings of these

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[8] *Bowcut*, furthermore, has been widely interpreted as approving the "single transaction" test first articulated in *Herring*. *Cf. Wilmington Trust Co. v. United States*, 1979 WL 3928, 20 (Ct. Cl. Trial Div.) (referring to the equitable recoupment rule as applied in *Herring* and *Bowcut*); *In re Carter*, 125 B.R. 832, 836 (Bankr. D. Kan. 1991) (same); *Wilmington Trust Co. v. United States*, 221 Ct. Cl. 686, 610 F.2d 703, 713 (1979) (describing holding of *Herring* and *Bowcut* as the same).

[9] The Commissioner has nevertheless adopted the *Herring*/*Bowcut* holdings in its own administrative procedures. Under Rev. Rul. 71-56, it is the IRS's view that an estate tax overpayment may be equitably recouped from an assessed deficiency when the overpayment automatically results from a finding of a pre-death income tax underpayment. If payment of the income tax deficiency would reduce the size of the estate and, consequently, lower the estate tax owed, the overpaid estate tax may be recouped from the underpaid income tax.

This ruling resulted from the Commissioner's interpretation of *Herring*, *Bowcut* and other Circuit Court decisions. "Based on the availability of such legal defense, it would be proper for the

cases need not be "stretched" any further to accommodate the facts of this case. In *Herring* and *Bowcut*, as in this case, a single "item" or fund was subject to two inconsistent taxes because it was simultaneously treated as both an asset of the estate and income to an individual. *See also United States v. Dalm*, 494 U.S. at 608 n. 5, 110 S. Ct. 1361 (recoupment appropriate where single "transaction, item, or taxable event" subject to inconsistent taxes). *Herring* and *Bowcut* make clear that an estate tax overpayment may be used to satisfy an income tax deficiency where there is a sufficient statutory interrelationship between the overpaid and underpaid taxes. In both cases, as here, the conclusion that the time-barred tax was overpaid automatically arose from the Tax Court's finding of a deficiency in the disputed tax.

Therefore, we hold that the "single transaction" prerequisite to equitable recoupment is satisfied where the same item (the closed corporation stock) is taxed as both the corpus of the estate and income to the beneficiary. The government should not be permitted to reap the benefit of the higher valuation when collecting the estate tax and, simultaneously, reap the benefit of

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taxpayer to claim in a proceeding before the Internal Revenue Service appropriate reduction in the deficiency, rather than be required to assert the claim of equitable recoupment in the Federal courts." Rev. Rul. 71-56. This rule, moreover, has been applied broadly to permit recoupment of gift taxes from estate taxes, income taxes from excise taxes, and income taxes from estate taxes where the relation between the taxes is statutorily mandated. Arthur W. Andrews, *Modern-Day Equitable Recoupment and the "Two Tax Effect": Avoidance of the Statutes of Limitation in Federal Tax Controversies*, 28 Ariz. L. Rev. 595, 637 (1986) (citing cases decided under Rev. Rul. 71- 56).

the lower valuation when collecting the beneficiary's income tax.

This holding is consistent with the decisions of other circuits. In *O'Brien v. United States*, 766 F.2d 1038 (7th Cir. 1985), for example, a taxpayer sought refund of an income tax overpayment after a separate estate tax deficiency proceeding determined that the stock valuation on which the income tax payment was based was improper. The court rejected this claim, holding that it was not recoupment the taxpayer was seeking, but rather a cash refund from the Commissioner. "Attempts by taxpayers to utilize the doctrine to revive an untimely affirmative refund claim, as opposed to offset a timely government claim of deficiency . . . have been uniformly rejected." *O'Brien*, 766 F.2d at 1049.

However, in dicta, the court noted that "the 'single transaction' test . . . appears to be satisfied on these facts . . . [because] inconsistent treatment of the same stock (in terms of valuation) has directly resulted in the overpayment of tax by the beneficiaries." *Id.* at 1051 n.16; *See also Boyle*, 355 F.2d at 233 (equitable recoupment of overpaid estate taxes permitted where specific fund treated as both asset of the estate and income to the beneficiaries); *Estate of Vitt v. United States*, 706 F.2d 871 (8th Cir. 1983) (decedent's life estate a single item and taxpayer is entitled to recoupment for inconsistent valuation rendered a decade earlier); *But cf. Wilmington Trust Co. v. United States*, 221 Ct. Cl. 686, 610 F.2d 703 (Ct. Cl. 1979) (government could not offset estate tax underpayment against income tax refund).

In short, the weight of Circuit court case law (and the IRS's own rulings) support a finding that the estate's tax deficiency and the beneficiary's income tax overpayment were a single transaction for equitable recoup-

ment purposes. The deficiency and overpayment resulted from separate valuations of a single item (the Willits and Savings stock). The declared value of the item was increased in a Tax Court proceeding, resulting in an estate tax deficiency. The lower, erroneous value, however, had also been used (as required by 26 U.S.C. § 1014) to determine Appellee's income tax liability. The interrelationship between the taxes is such that the inconsistent treatment of the same funds automatically resulted in double taxation and an unjust windfall to the government.

B. *Appellee's Lack of Diligence*

Appellee received notice of the estate tax deficiency in March 1995. The statute of limitations for a refund of March's income tax did not expire until April 1996. Upon receipt of the notice of deficiency, March still had thirteen months to file a protective claim for a refund, yet she failed to take advantage of this opportunity. The Commissioner argues that March's lack of diligence in pursuing the refund claim renders her undeserving of the equitable remedy of recoupment.

A similar argument was raised by the government in *United States v. Bowcut*, 287 F.2d at 657. In *Bowcut*, the taxpayer was notified of an income tax deficiency five weeks before the statute of limitations for seeking a refund of her estate tax overpayment expired. The government argued that the taxpayer's "lack of diligence in seeking refund of the estate tax" should prevent a subsequent equitable recoupment claim. *Id.* The court rejected this argument. Relying on *Bull v. United States*, 295 U.S. 247, 55 S. Ct. 695, 79 L. Ed. 1421, the court held: "It is apparently not the diligence of the taxpayer as to his legal rights which controls, but

rather the inequity of holding that, while the government's rights under a transaction continue unimpaired, its adversary's rights thereunder are barred by limitations." *Bowcut*, 287 F.2d at 657; *See also Holzer v. U.S.*, 250 F. Supp. 875, 878 (E.D. Wis.) aff'd per curiam, 367 F.2d 822 (7th Cir. 1966) ("laches is not a defense to a claim for equitable recoupment"); *Teco Inv., Inc. v. Taxation and Revenue Dep't of the State of N.M.*, 125 N.M. 103, 957 P.2d 532, 537 (Ct. App. 1998) (additional equitable considerations cannot be used "to trump the . . . elements of the test and deny equitable relief").

Recognizing that *Bull* and *Bowcut* are controlling on this point, the Commissioner argues that Appellee's negligence in this case was more egregious than previous taxpayers who have successfully raised an equitable recoupment defense. Appellee disputes this point. Resolution of this question, however, does not depend on whether Appellee was more or less negligent than previous taxpayers.

Even under a narrow reading of *Bowcut*, a taxpayer who was on notice of a possible overpayment five weeks before the expiration of the statute of limitations, yet failed to file a timely claim, could recoup that overpayment from an income tax deficiency. We find no principled distinction between *Bowcut* and the facts of the present case. It is true that the taxpayer here had thirteen months, rather than five weeks, to file a protective claim for a refund. However, we are unable to divine when a taxpayer's lack of diligence would "cross the line" from excusable to legally significant. The Commissioner offers no judicially cognizable standard to resolve this dilemma and the rationale of *Bowcut* suggests that such a line should not be drawn.

IV

Conclusion

The Tax Court properly considered and correctly applied the doctrine of equitable recoupment in this case. The Tax Court has the authority to apply equitable doctrines in cases subject to its jurisdiction. As the estate tax deficiency was properly before that court, it was required to consider that deficiency in its totality. This required consideration of the affirmative defense of equitable recoupment. No provision of the Tax Code prevents the Tax Court from exercising this power. In addition, the estate satisfied all the criteria necessary to recoup its time barred overpayment from the adjudicated estate tax deficiency.

The judgment of the Tax Court is affirmed.

APPENDIX B

UNITED STATES TAX COURT

No. 10028-95

ESTATE OF FRANK BRANSON, DECEASED; MARY M. MARCH, EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[July 13, 1999]

MEMORANDUM FINDINGS OF FACT AND OPINION

PARR, J.

Respondent determined a deficiency of $756,564 in petitioner's Federal estate tax.

The issues for decision are: (1) Whether the fair market value of 12,889 shares of Savings Bank of Mendocino County (Savings) on the date of decedent's death was $300 per share as respondent determined in the notice of deficiency; $181.50, as petitioner reported on its estate tax return; or some other amount. We hold it was $276 per share. (2) Whether the fair market value of 500 shares of common stock of Bank of Willits (Willits) on the date of decedent's death was $850 per share, as respondent determined in the notice of deficiency; $485 per share, as petitioner reported on its

estate tax return; or some other amount. We hold it was $626 per share. (3) Whether, under section 2053,[1] petitioner may deduct certain expenses incurred in defending its reporting position. We hold it may.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, supplemental stipulation of facts, and second supplemental stipulation of facts, and the accompanying exhibits are incorporated herein by this reference.

Petitioner is the estate of Frank A. Branson (decedent), who died testate on November 9, 1991, in Mendocino, California. Mary March (March), decedent's daughter, is the executrix and residuary legatee of the estate. March's legal address was Potter Valley, California, at the time the petition in this case was filed.

A. *Decedent's Stock Acquisitions*

Decedent inherited 12,369 shares of Savings stock and 1,143 shares of Willits stock from his wife, Charlotte, in 1983. The balance of the Savings shares owned by decedent at the time of his death was obtained either as gifts from his father-in-law or by purchase.

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[1] All section references are to the Internal Revenue Code in effect as of the date of decedent's death, and all Rule references are to the Tax Court. Rules of Practical and Procedure, unless otherwise indicated. All dollar amounts are rounded to the nearest dollar, unless otherwise indicated.

B. *Savings Bank of Mendocino*

1. *Background*

In 1991, Savings was headquartered in Ukiah, California, and had seven branch offices. Savings was founded on November 28, 1903, by Judge J.M. Mannon (J.M.) and a few other investors who contributed $50,000 in total to the venture. J.M. was elected president of Savings in 1914, and upon his death in 1926, his son, Charles M. Mannon (C.M.), who was also one of the original stockholders, was named president of Savings. C.M. was the father of Charlotte, decedent's wife. Decedent began working for Savings in 1935, and served as its president from 1964 until 1976, when he became a director. At the time of trial, Charles B. Mannon (Mannon), the grandson of C.M. and decedent's nephew and March's cousin, was president and chief executive officer of Savings and a director and the chairman of the board of Willits.

Savings' stock is not traded on any established exchange or over-the-counter market.

2. *Net Income*

For the 12 months that ended on October 31, 1991, Savings had net income of $4,149,000. For the years

1986 through 1990,[2] Savings had net income as follows:

Year	Net Income
1986	$2,531,000
1987	2,825,000
1988	3,048,000
1989	3,128,000
1990	3,481,000

Savings' net income increased on average by approximately 10.39 percent per annum for the 5 years preceding decedent's death.

Savings has never had a negative income year. Earnings for 1991 were the best ever. Furthermore, provisions for loan losses decreased from $670,000 (3.6 percent of total interest income) in 1986, to $310,000 (1.1 percent of total interest income) in 1991. Thus, during this time, provisions for loan losses decreased both on an absolute basis and as a percentage of interest income.

3. *Dividend History*

Savings has a consistent history of paying dividends. For the 12 months that ended on October 31, 1991, Savings paid common stock dividends of $8.40 per share.

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[2] The results of the years 1986 through 1990 are for 12 months that ended on December 31. Net income for the 12 months that ended on Dec. 31, 1991, was $4,278,207, which is 23 percent higher than the same period in 1990.

For the years 1986 through 1990, Savings paid dividends as follows:

Year	Dividends Paid Per Share
1986	$4.60
1987	5.60
1988	6.60
1989	7.20
1990	7.80

Thus, dividends paid increased every year for the 5 years preceding decedent's death, on average by approximately 12.8 percent per annum.

4. *Total Assets and Shareholder's Equity*

At all relevant times, Savings has had 100,000 shares of common stock issued and outstanding. As of October 31, 1991, Savings had total assets of $295,428,000 and shareholder's equity of $28,344,000.

As of December 31, 1986 through 1990, Savings had total assets and shareholder's equity as follows:

Year	Total Assets	Shareholder's Equity
1986	$ 200,959,000	$ 15,757,000
1987	228,705,000	18,023,000
1988	243,348,000	20,410,000
1989	266,638,000	22,817,000
1990	281,322,000	25,515,000

Thus, total assets and shareholder's equity increased on average by approximately 8.0 and 12.46 percent per annum, respectively, for the 5 years preceding decedent's death.

5. *Ownership*

At the date of valuation, the shares of Savings stock were distributed among 215 shareholders as follows:

Shareholder	No. of Shares	Percentage
Estate of Frank A. Branson	12,889	12.89
Charles B. Mannon	16,716	16.72
Everett & Martha Coe	17,355	17.35
Others[1]	53,040	53.04
Total	100,000	100.00

[1] The shares held by others are widely distributed, with many of the shareholders owning less than 3 percent.

6. *Sales of Savings Stock*

The investment department of Savings maintains an informal list of people who are interested in buying shares of its stock. Usually, when a shareholder wants to sell his or her shares, the shareholder contacts Savings, which informs the shareholder of the most recent sale price and the current book value of the stock. Savings then assists the shareholder in finding a buyer willing to pay the price that the shareholder requires. Historically, Savings shares have traded at or near book value.

Since 1980, there have been several sales of blocks of several hundred shares. In each of these sales, the shares changed hands on a single day and all the shares traded for the same price per share, although most of the buyers each purchased less than 100 shares. No blocks of Savings stock comparable to the size owned by petitioner have ever been sold; the only shareholders who have ever owned blocks of that size are members of the Mannon family or their relatives, and

none of them have ever tried to sell their entire interests.

However, on October 9, 1991, decedent sold a total of 1,111 shares for $307 per share to approximately 20 buyers; the book value on October 31, 1991, was $283.44 per share. On August 27, 1992, petitioner sold 2,800 shares for $335 per share to approximately 45 buyers;[3] the 1992 third-quarter book value was $321.74 per share.[4] Savings assisted petitioner in this sale, and petitioner made no attempt to sell these shares in any way other than through Savings.

C. *Bank of Willits*

1. *Background*

Willits has two branches and provides a full range of banking services to individual and commercial customers. Willits was incorporated on April 11, 1904, and began business with $50,000 of paid-in capital. Dece-

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[3] The stipulated amount of this sale is $935,000 (which is $333.93 per share); however, the amount reported on petitioner's Form 1041, U.S. Fiduciary Income Tax Return, for 1992 is $938,000 ($335 per share). Furthermore, at trial respondent introduced evidence, a list of sales of Savings shares after 1989 and a list of sales of Savings shares from 1980 through 1992, which show the price per share was $335. While stipulations are not set aside lightly, we have broad discretion in determining whether to hold a party to a stipulation. See *Blohm* v. *Commissioner*, 994 F.2d 1542, 1553 (11th Cir. 1993), affg. T.C. Memo. 1991-636. The evidence in the record demonstrates that the stipulated amount is simply incorrect. We are not bound by stipulations of fact that appear contrary to the facts disclosed by the record. See Rule 91(e); *Blohm* v. *Commissioner*, *supra*. We, therefore, find as a fact that the 1,111 shares were sold for $938,000 ($335 per share) on Aug. 27, 1992.

[4] 24 The Western Bank Monitor 123 (1993).

dent's father-in- law, C.M., was Willits' president from 1928 until 1957. Willits' stock is not traded on any established exchange or over-the-counter market.

2. *Net Income*

For the 12 months that ended on September 30, 1991, Willits had net income of $819,000. For the years 1986 through 1990,[5] Willits had net income as follows:

Year	Net Income
1986	$624,000
1987	659,000
1988	714,000
1989	711,000
1990	734,000

Thus, net income increased on average by approximately 5.59 percent per annum during the 5 years preceding decedent's death. Furthermore, except for 1989, net income increased every year.

During this time, the provision for loan losses increased from $55,000 in 1986 to $70,000 in 1991; however, it decreased as a percentage of total interest income from 1.41 percent in 1986 to 1.29 percent in 1991.

3. *Dividend History*

Willits has a history of paying dividends. Dividends paid increased each year during the 5 years preceding decedent's death. For the 12 months that ended on September 30, 1991, the dividends were $29 per share.

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[5] The results of the years 1986 through 1990 are for 12 months that ended on December 31.

For the years 1986 through 1990, Savings paid dividends as follows:

Year	Dividends Paid Per Share
1986	$18
1987	22
1988	24
1989	26
1990	28

Thus, dividends paid increased during this measurement period on average by approximately 10.01 percent per annum.

4. *Assets and Shareholder's Equity*

At all relevant times, Willits had 8,000 shares of common stock issued and outstanding. As of September 30, 1991, total assets were $54,929,000 and shareholder's equity was $6,448,000.

As of December 31, 1986 through 1990, Willits had total assets and shareholder's equity as follows:

Year	Total Assets	Shareholder's Equity
1986	$40,665,000	$4,013,000
1987	41,442,000	4,496,000
1988	47,540,000	5,017,000
1989	52,290,000	5,236,000
1990	54,666,000	5,716,000

Thus, total assets and shareholder's equity increased each year during the 5 years preceding decedent's death; total assets increased on average by approximately 6.20 percent per annum and shareholder's equity by 9.94 percent per annum.

5. *Ownership*

At the date of valuation, the shares of Willits stock were distributed among 48 shareholders as follows:

Shareholder	No. of Shares	Percentage
Estate of Frank A. Branson	500	6.25
Charles B. Mannon	2,441	30.51
Everett & Martha Coe	1,414	17.68
Others[1]	3,645	45.56
Total	8,000	100.00

[1] Of the shares held by others, 19.9 percent are owned by two out-of-State shareholders and the balance by local residents who own very small percentages.

6. *Sales of Willits Stock*

Historically, very few Willits shares have been traded each year. A total of 1,062 shares changed hands in 22 transactions from February 1980 until the valuation date. No shares were sold during 1987 or for more than 4 years after April 1988. Most of the sales were by Willits board members either to Willits employees, board members, or directors, or to induce qualified persons to become board members or officers. For instance, in 1980 a total of 64 shares was traded in four sales, 60 of those shares were sold as qualifying shares by a board member to three persons hired by Willits; two as executive officers and one as a director. Similarly, the only shares that changed hands in 1981 were 20 qualifying shares, which Mannon sold as an inducement to a new board member; in 1982, the only shares traded were 20 shares sold by a departing executive officer to an incoming officer. The most recent sale before the valuation date was Mannon's sale of 20

qualifying shares to Dick Bozarth (Bozarth) on March 23, 1988, for $500 per share.

Consequently, in these 22 transactions there were only six sellers and three buyers who were not Willits employees, board members, or directors. Most of the sellers, with the exception of decedent, sold few shares; decedent sold 674 shares. Most of the buyers, with the exception of Mannon, purchased minimal interests. Mannon was a buyer in seven of the sales and purchased a total of 663 shares; 572 from members of his family and 91 from other sellers.

Historically, Willits shares have traded at or near book value. For instance, decedent sold 174 of the Willits shares in 1984 for $56,550 ($325 per share) and 500 shares between December 1985 and January 1986 for $190,000 ($380 per share).[6] The selling price of these shares was near their book value. The book value of the Willits stock on September 30, 1991, was $806 per share.

Petitioner sold 500 shares on August 12, 1992, for $425,000 ($850 per share). The book value of the shares on July 31, 1992, was $875 per share. Petitioner did not independently value the shares before the sale; rather, March and Mannon used the book value of the stock as a reference to set the sale price.

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[6] The parties stipulated that decedent sold 424 shares for $151,550 ($357.43 per share) in 1985. However, this stipulation is contrary to a buyer's (Mannon's) testimony and a list of all the sales of Willits shares from 1980 through 1992, which was offered into evidence as a joint exhibit. The evidence in the record demonstrates that the stipulation is incorrect. We, therefore, find as a fact that decedent sold 500 shares for $380 per share between December 1985 and January 1986. See *supra* note 3.

Furthermore, petitioner did not contact or engage any brokers or agents for this sale. Instead, March asked Mannon to find buyers for the stock. Mannon confined his search for buyers to the Willits board of directors. Rebecca Brown, an executive officer and shareholder, bought 10 shares; Bozarth, a board member and shareholder, bought 125 shares in the name of his logging company; and Mannon bought 365 shares (10 of which he gave to a longtime employee).

D. Petitioner's Sales and March's Recognition of Gain

Under decedent's will, the 12,889 shares of Savings stock and the 500 shares of Willits stock were distributed as follows: (1) 4,000 shares of Savings stock in trust for the benefit of decedent's widow during her life, and upon her death, the remainder to be distributed to March; (2) 1,000 shares of Savings stock in trust for each of decedent's four grandchildren; and (3) the remaining 4,889 shares of Savings stock and 500 shares of Willits stock to March as part of the residue of the estate. The will provided that all estate taxes were to be paid from the residue of the estate.

Pursuant to a court order, March was granted authority to sell 2,800 shares of Savings stock at $335 per share and 500 shares of Willits stock at $850 per share. March sold the shares and paid Federal and State of California estate taxes of $1,008,698 and $200,632, respectively. March, as executrix and residuary legatee, assumed individual liability for any estate taxes later found due from petitioner.

Petitioner reported the value of the Savings and Willits shares as $181.50 and $485, respectively, per share, on its Form 706, United States Estate (and

Generation-Skipping Transfer) Tax Return. Petitioner reported the capital gain from the sales of the Savings and Willits shares on Schedule D of its 1992 Form 1041, U.S. Fiduciary Income Tax Return, which it filed on or about April 15, 1993. Petitioner calculated the gain by subtracting the value of the shares reported on the estate tax return from the amount received from their sale. Petitioner reported $429,800 of gain from the sale of the Savings shares and $182,500 from the sale of the Willits shares[7]. Petitioner, however, did not pay any tax on these gains; instead, it reported a net long-term capital gain distribution of $610,274 to March on Schedule K-1, Beneficiary's Share of Income, Deductions, Credits, Etc., which it attached to the Form 1041.

March and her husband, Charles March, filed their 1992 Form 1040, U.S. Individual Income Tax Return, using the status of "Married filing joint return", on or about April 15, 1993, and paid the tax due. March reported the $610,274 gain on line 13 of Schedule D, which was attached to the Form 1040, as "Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries".

E. *Petitioner's Claim for Deductions*

After filing the Form 706, petitioner paid $21,226 of attorney's fees, $8,830 of accountant's fees, and $12,396 of appraisal costs to defend its reporting position in an audit by the Internal Revenue Service. Petitioner filed Form 843, Claim for Refund and Request for Abatement, to claim a refund of the estate tax paid on these

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[7] Petitioner also reported $6,955 of long-term capital gain from the sale of 2,000 shares of PG & E stock and a $738 net long-term capital loss carryover from 1991. The value of the PG & E shares and the loss carryover are not at issue in this case.

amounts. In addition, petitioner filed a protective claim for refund of estate tax for additional administrative expenses that it expects to incur in further defending its position.

OPINION

Respondent determined a deficiency of $756,564 in petitioner's 1991 Federal estate tax. Respondent's determination was based upon his contention that the date-of-death fair market values of the 12,889 Savings shares and the 500 Willits shares were $3,866,700 ($300 per share) and $425,000 ($850 per share), respectively. Respondent now argues that the values of the Savings and Willits shares were no less than $3,776,477 ($293 per share) and $386,000 ($774 per share), respectively. Respondent's determination as to the fair market value of the subject property is presumptively correct, and petitioner bears the burden of proving that the fair market value is lower. See Rule 142(a); *Welch* v. *Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212 (1933).

Petitioner asserts that the values it reported on its return for the Savings shares, $2,339,354 ($181.50 per share), and the Willits shares, $242,500 ($485 per share), are correct; however, it argues that if this Court decides that there is a deficiency, it is entitled to equitable recoupment of the tax paid on the gain recognized by March due to the lower bases provided by the values petitioner reported on its estate tax return.

Finally, petitioner asserts that it is entitled to deduct certain expenses from the value of the gross estate. The expenses are attorney's fees, accountant's fees, and appraisal costs which were incurred after the estate tax return was filed to prove the shares' reported values.

Fair Market Value

Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. See *United States* v. *Cartwright*, 411 U.S. 546, 551, 93 S. Ct. 1713, 36 L. Ed. 2d 528 (1973); *Propstra* v. *United States*, 680 F.2d 1248, 1251 (9th Cir. 1982); sec. 20.2031-1(b), Estate Tax Regs. This is an objective test and requires the property to be valued from the viewpoint of a hypothetical buyer and seller, each of whom would seek to maximize his or her profit from any transaction involving the property. See *Propstra* v. United States, *supra* at 1251-1252; *Estate of Jung* v. *Commissioner*, 101 T.C. 412, 438, 1993 WL 460544 (1993). Profit maximization must be achieved in the context of the market conditions and the constraints of the economy existing at the valuation date. See *Estate of Newhouse* v. *Commissioner*, 94 T.C. 193, 218, 1990 WL 17251 (1990).

For Federal estate tax purposes, the fair market value of the subject property is generally determined as of the date of death of the decedent; ordinarily, no consideration is given to any unforeseeable future event that may have affected the value of the subject property on some later date. See sec. 20.2031-1(b), Estate Tax Regs.; see also *First Natl. Bank of Kenosha* v. *Unites States*, 763 F.2d 891, 893-894 (7th Cir.1985); *Estate of Newhouse* v. *Commissioner*, *supra*; *Estate of Gilford* v. *Commissioner*, 88 T.C.38, 52, 1987 WL 49260 (1987).

The question of "Valuation of stock for tax purposes is a matter of 'pure fact.'" *Hamm* v. *Commissioner*, 325 F.2d 934, 938 (8th Cir. 1963) (quoting *Penn* v. *Com-*

missioner, 219 F.2d 18, 20-21 (9th Cir. 1955)), affg. T.C. Memo. 1961-347; *Estate of Newhouse* v. *Commissioner*, *supra* at 217; see also *In re Nathan's Estate* v. *Commissioner*, 166 F.2d 422, 425 (9th Cir. 1948) (the question of fair market value for tax purposes is ever one of fact and not of formula), affg. a Memorandum Opinion of this Court dated July 17, 1946.

While listed market prices are the benchmarks in the case of publicly traded stock, in determining the value of unlisted stocks, actual sales made in reasonable amounts at arm's length, in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value. See *Estate of Fitts* v. *Commissioner*, 237 F.2d 729, 731 (8th Cir. 1956), affg. T.C. Memo.1955-269; *Estate of Andrews* v. *Commissioner*, 79 T.C. 938, 940, 1982 WL 11197 (1982); *Duncan Indus., Inc.* v. *Commissioner*, 73 T.C. 266, 276, 1979 WL 3700 (1979); *Estate of Campbell* v. *Commissioner*, T.C. Memo. 1991-615; sec. 20.2031-2(b), Estate Tax Regs.

If it is established that the value of any share of stock determined on the basis of selling price does not reflect the fair market value thereof, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value. See sec. 20.2031- 2(e), Estate Tax Regs.

Issue 1. Fair Market Value of the Savings Shares

The parties agree that the best indication of the Savings stock's market value is the actual sale price of the shares. Petitioner, however, asserts that the actual sale price is just the starting point for deciding fair market value—that discounts should be applied to the sale price for minority interest, lack of marketability,

and blockage. Respondent contends that the actual sale price reflects the discount for minority interest and lack of marketability. Respondent further contends that in view of the higher prices received for the shares sold in the post-death market, no significant discount for blockage is appropriate. We agree with respondent.

Expert Witnesses

Both sides submitted expert witness reports and presented expert witness testimony in regard to the value of decedent's shares of Savings stock at the date of death.

Expert witness testimony is appropriate to help the Court understand an area requiring specialized training, knowledge, or judgment. See Fed. R. Evid. 702; *Snyder v. Commissioner*, 93 T.C. 529, 534, 1989 WL 129656 (1989). The Court, however, is not bound by an expert's opinion. We weigh an expert's testimony in light of his or her qualifications and with respect to all credible evidence in the record. Depending on what we believe is appropriate under the facts and circumstances of the case, we may either reject an expert's opinion in its entirety, accept it in its entirety, or accept selective portions of it. See *Helvering v. National Grocery Co.*, 304 U.S. 282, 294-295, 58 S. Ct. 932, 82 L.Ed. 1346 (1938); *Seagate Tech., Inc. & Consol. Subs. v. Commissioner*, 102 T.C. 149, 186, 1994 WL 34636 (1994). Moreover, where experts offer divergent estimates of fair market value, we decide what weight to give these estimates by examining the factors they used in arriving at their conclusions. See *Casey v. Commissioner*, 38 T.C. 357, 381, 1962 WL 1092 (1962). We have broad discretion in selecting valuation methods, see *Estate of O'Connell v. Commissioner*, 640 F.2d 249, 251 (9th Cir. 1981), affg. on this issue and revg. in

part T.C. Memo. 1978-191, and the weight to be given the facts in reaching our conclusion because "finding market value is, after all, something for judgment, experience, and reason", see *Colonial Fabrics, Inc. v. Commissioner*, 202 F.2d 105, 107 (2d Cir. 1953), affg. a Memorandum Opinion of the Court.

Where necessary, we may reach a determination of value based upon our own examination of the evidence in the record. See *Lukens v. Commissioner*, 945 F.2d 92, 96 (5th Cir. 1991) (citing *Silverman v. Commissioner*, 538 F.2d 927, 933 (2d Cir.1976), affg. T.C. Memo. 1974-285). Finally, because valuation is necessarily an approximation, it is not required that the value we determine be one as to which there is specific testimony, provided it is within the range of figures that properly may be deduced from the evidence. See *Silverman v. Commissioner, supra; Anderson v. Commissioner*, 250 F.2d 242, 249 (5th Cir. 1957), affg. in part and remanding in part T.C. Memo. 1956-178. With these principles in mind, we consider the experts' opinions.

Petitioner's Expert's Opinion

Petitioner's expert is John R. Gasiorowski (Gasiorowski). Gasiorowski is the director of Arthur Anderson & Co. Valuation Services in Northern California, and he has had extensive experience in valuing businesses. In his report, Gasiorowski used the market and income methods to value petitioner's Savings shares.

The market method measures the value of an asset through an analysis of recent sales or offerings of comparable property. If comparable publicly traded companies can be found, then the stock prices for those

companies can be used to derive benchmarks, such as financial ratios, which can be applied to the corresponding financial measures of the subject company to derive a value for its stock.

In applying this method, Gasiorowski first selected eight publicly traded banks with overall characteristics similar to Savings as "guideline companies". He then compared the guideline companies' operating results and financial positions from 1986 through the third quarter of 1991 with Savings' operating results and financial positions for the same time period. On the basis of this comparative analysis, Gasiorowski selected certain financial ratios to value the Savings shares. Giving equal weight to the price-to-earnings ratios, the price-to-book ratios, and the price-to-dividend ratios, Gasiorowski concluded that the "marketable minority value" of the Savings stock was $295 per share, before considering a discount for lack of marketability. The marketable minority value is Gasiorowski's "best estimate of what the Savings Bank stock might sell for if it were publicly traded."

The income method values an asset based upon the present value of its future economic benefits. To estimate the value of the Savings shares with this method, Gasiorowski interviewed Savings' management concerning the bank's future, and obtained its 1992 budget. Gasiorowski developed the discount rate used to calculate the present value of Savings' 1992 estimated net income by reducing the rate of return that he thought an equity investor in Savings would require by 4 percent, his estimate of Savings' long-term growth rate. Using this method, Gasiorowski concluded that the shares were worth $350, before considering a discount for lack of marketability.

Because Gasiorowski considered the market method data to be more reliable than the income method data, he gave the market method result greater weight, and concluded that the marketable minority value of the stock was $310.

Finally, Gasiorowski applied a 30-to 45-percent discount to the estimated marketable minority value for lack of marketability and liquidity. In selecting the size of the discount, Gasiorowski considered various studies of the differences between the private transaction prices for restricted shares of a corporation and the contemporaneous sales prices for publicly traded shares of the same corporation (the restricted stock studies),[8] and a series of initial public offering (IPO) studies that compared the prices of shares sold in an IPO to the prices of shares in the same corporation sold in relatively small amounts no more than 5 months earlier in private transactions (the IPO studies).[9]

To narrow the range of the discount, Gasiorowski considered Savings' 1991 revenues, positive earnings history, positive dividend growth history, payout ratio, and the expected long-term growth rates of its earnings and dividends. Gasiorowski concluded that these factors indicated that a discount at the lower end of the

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[8] Restricted stock is stock acquired from an issuer in a transaction exempt from the registration requirements of the Federal securities laws. Sales of restricted stock are generally restricted within the first 2 years after issuance.

[9] This was a series of updates to a study by John D. Emory. The most recent, Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock—November 1995 through April 1997", Bus. Valuation Rev. (Sept.1997), was the eighth in the series.

range would be appropriate, before considering the size of the block held by petitioner.

In considering the appropriate discount for the size of the block, Gasiorowski estimated that, based on the average number of shares traded in the 4 prior years, it would take petitioner more than 8 years to dispose of all its shares unless it was willing to sell them at a significant discount.[10] Accordingly, Gasiorowski tentatively concluded that a discount of 40 to 45 percent should be applied to the $310 indicated value, which resulted in a value of $170 to $186 per share.

However, before reaching a definite conclusion of the stock's value, Gasiorowski interviewed several experts who value closely held bank stocks. From his discussions with these experts, Gasiorowski concluded that if a block of stock of the size held by petitioner were publicly traded, it most likely would trade at 55 to 60 percent of book value. Applying this discount to the October 31, 1991, book value of the Savings stock suggested a public market value of $156 to $170 per share. Thus, Gasiorowski concluded that the date-of-death fair market value of petitioner's shares was $170

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[10] At trial, Gasiorowski denied using the term "blockage" in his report. However, we note that in his written report, Gasiorowski opined that "it would be difficult to sell the 12,889 shares held by the Estate without incurring a significant discount for the sale of the entire block." Furthermore, Gasiorowski testified that "after considering the size of the block, we thought the discount for lack of marketability would be in the 40 to 45 percent range." Thus, it is evident that when Gasiorowski considered the marketability of the Savings shares, he considered the effect of blockage, and that his estimate of the discount for lack of marketability includes a component for blockage.

per share. We do not find petitioner's opinion persuasive.

Discounts for a Minority Interest and Lack of Marketability

A minority interest discount reflects the minority shareholder's inability to compel either the payment of dividends or liquidation in order to realize a pro rata share of a corporation's net earnings or net asset value. A lack of marketability discount reflects the fact that there is no ready market for shares in a closely held corporation. Thus, discounts for a minority interest and for lack of marketability are conceptually distinct, and the appropriate percentage rate of each of them is a question of fact. See *Estate of Newhouse v. Commissioner*, 94 T.C. at 249. Gasiorowski concluded that if the stock were publicly traded, the value of a minority interest would be $310 per share. This estimated value reflects the discount for a minority interest in Savings; therefore, the 45-percent discount that Gasiorowski would apply to the estimated value must be for only the lack of marketability of petitioner's block of shares.

We find Gasiorowski's reliance on the restricted stock studies for the size of the discount factor to be misplaced, since the studies analyzed only restricted stock that had a holding period of 2 years. The Savings shares were not restricted either by law or by agreement. The fact that Savings maintained a waiting list of willing buyers is evidence that the stock's history of low trading volume is due to the shareholder's preference to hold Savings shares for investment, rather than for sale. As the investment time horizon of an investor in Savings stock evidently is long term, we do not believe that marketability concerns rise to the same level as a security with a short-term holding

period like a restricted stock. See *Furman v. Commissioner*, T.C. Memo. 1998-157. Therefore, we find no persuasive evidence in the record to support reliance on the restricted stock studies in determining an appropriate marketability discount.

Furthermore, we do not find Gasiorowski's conclusions with respect to the IPO study persuasive. The IPO study compared the sales prices of relatively small amounts of a corporation's shares before they were offered to the public to the sales prices of the same shares sold later in an IPO. The study concluded that the sales prices in the nonpublic markets were 40 to 45 percent less than sales prices in the IPO's. Thus, Gasiorowski concluded that the estimated marketable minority value, which he implicitly assumes is equal to an IPO value, should be reduced by 45 percent to reflect the nonpublic market value of the shares. We reject this conclusion for the following reasons.

Petitioner offered no evidence that the value of the shares was affected by any change in the market conditions, the constraints of the economy, or the financial condition of Savings between the date of decedent's arm's-length sale of 1,111 shares for $307 per share in the nonpublic market and the valuation date 1 month later. Consequently, if we apply the conclusions of the IPO study to the case at hand, we find that it is more likely that $307 is 40 to 45 percent less, rather than more, than the price at which the same shares would sell in an IPO.

Furthermore, Gasiorowski disregards the fact that the actual sales value of the shares is nearly identical to his estimated marketable minority value. The near identity of values indicates that the marketability of the Savings shares in the nonpublic market is essentially

equal to that of a minority interest in the public market, in which case no discount for marketability is required for a minority interest in Savings.

Discount for Blockage

Finally, Gasiorowski considered the lack of marketability due to the size of the block of shares held by petitioner.

The discount for blockage is based upon the theory that a large block of stock cannot be marketed and turned into cash as readily as a few shares; also, where there is only a limited market for a stock, offering a large block of the stock depresses the market and lowers the price that can be obtained. See *Estate of Sawade v. Commissioner*, T.C. Memo. 1984-626, affd. 795 F.2d 45 (8th Cir. 1986); *Richardson v. Commissioner*, 151 F.2d 102, 103 (2d Cir. 1945), affg. a Memorandum Opinion of this Court; *Phipps v. Commissioner*, 127 F.2d 214, 216 (10th Cir. 1942), affg. 43 B.T.A. 1010 (1941); *Safe Deposit & Trust Co. v. Commissioner*, 35 B.T.A. 259 (1937), affd. 95 F.2d 806 (4th Cir. 1938); sec. 20.2031-2(e), Estate Tax Regs.[11] However, there is no presumption of blockage. See *Maytag v. Com-*

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[11] In this regard, sec. 20.2031-2(e), Estate Tax Regs., provides:

> In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. * * *

missioner, 187 F.2d 962 (10th Cir. 1951), affg. a Memorandum Opinion of this Court; *du Pont v. Commissioner*, 2 T .C. 246, 255, 1943 WL 24 (1943); *Safe Deposit & Trust Co. v. Commissioner, supra.* Blockage is not a law of economics, a principle of law, or a rule of evidence. Blockage is a question of fact. See *Estate of Sawade v. Commissioner, supra; Estate of Christie v. Commissioner*, T.C. Memo. 1974-95. "If the price obtainable for a block of stock is influenced by the size of the block, the existence and extent of this influence must be proven." *Estate of Christie v. Commissioner, supra.* Petitioner bears the burden of proof in this regard. See Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L. Ed. 212 (1933); sec. 20.2031-2(e), Estate Tax Regs.

In valuing a block of stock, we are not required to assume that the entire block was dumped on the market at one time on the valuation date. Rather, the inquiry must be directed to the effect upon the market based on the assumption that the block was being fed out into the market during a reasonable period of time. See *Estate of Van Horne v. Commissioner*, 78 T.C. 728, 742, 1982 WL 11084 (1982), affd. 720 F.2d 1114 (9th Cir. 1983); *Avery v. Commissioner*, 3 T.C. 963, 971, 1944 WL 141 (1944); *Estate of Sawade v. Commissioner, supra.* What is a reasonable period of time depends upon all the facts and circumstances. See *Estate of Sawade v. Commissioner, supra.*

Gasiorowski concluded that, because of the stock's history of low trading volume, it would be difficult to dispose of petitioner's block of shares without incurring a significant discount or devaluing the holding by dribbling it into the local market over a period of time

exceeding 8 years. We do not agree with this conclusion.

Evidence of the quantity of shares that can be sold without depressing their price is relevant to determining the magnitude of the discount, if any, that should be applied to their value for blockage. Therefore, we consider the number of shares that were sold within a reasonable time of decedent's death, as well as the price at which they sold, indicative of the fair market value of the shares at the valuation date.

Gasiorowski based his estimate of the amount of time it would take petitioner to dribble its stock into the local market on the average number of shares sold per year during the 11 years prior to decedent's death. We have found that the waiting list of willing buyers maintained by Savings is evidence that the stock's low trading volume is due to the shareholder's preference for holding the shares for investment, not the lack of willing buyers. By averaging the sales volumes of the prior years, Gasiorowski diluted the evidence of the number of shares that have been sold by willing sellers to willing buyers at any particular time with the total number of shares that were offered for sale over 11 years.[12] Furthermore, we have stated that later-occurring events that evidence fair market value may be taken into account. See *Estate of Jung v. Commissioner*, 101 T.C. at 431; see also *Estate of Newhouse*

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[12] For instance, 228 shares changed hands in 1990, 1,534 in 1991, and 3,000 in 1992. The average number of shares sold per year over this 3-year period is almost 7 times the number sold in 1990, and is about one- half the number of shares sold in 1992. Thus, the average number of shares sold per year over the 3-year period does not necessarily represent the number of shares sold in any particular year, or by a willing seller at any time.

v. Commissioner, 94 T.C. at 218 n.15. In estimating the number of shares that could be sold per year, Gasiorowski did not consider petitioner's sale of 2,800 shares less than 10 months after the date of decedent's death. Accordingly, we find little in Gasiorowski's methodology to support his opinion of the length of time it would take to dispose of petitioner's shares.

As an alternative to dribbling petitioner's shares into the local market, Gasiorowski considered the consequences of disposing the block in the public market. Gasiorowski interviewed several experts who value closely held bank stocks for their opinion of the price at which petitioner's stock would trade if it were offered on the public market. The experts' opinion was that the stock could be expected to trade at a price ranging from 50 to 70 percent of book value, and most likely at a price of 55 to 60 percent of book value.[13] Considering the nonpublic market that existed at the relevant time and the prices for which Savings shares actually were sold,[14] we think it extremely unlikely that any willing seller, not under any compulsion to sell and seeking to maximize his or her profit, would choose to sell his or her shares in the public market at a 45-to 50-percent discount from book value. We reject this portion of petitioner's expert opinion.

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[13] The experts assumed that only petitioner's shares would be offered on the public market.

[14] The total number of shares that changed hands during the 12 months beginning on Oct. 9, 1991, is 4,136. This amount includes the 1,111 shares sold by decedent and the 2,800 sold by petitioner. All these shares sold for more than book value.

Respondent's Expert's Opinion

Respondent's expert is Herbert T. Spiro (Spiro). Spiro is the president of American Valuation Group, Inc., and he has performed many valuations for respondent in the past. In his report, Spiro considered the actual sales values and used the market and income methods to value petitioner's Savings shares. Spiro ultimately concluded that the fair market value of the stock was $3,776,477 ($293 per share).

Spiro found seven publicly traded bank companies that were sufficiently comparable to Savings to use for the market method of valuation. Employing a methodology similar to that used by petitioner's expert, Spiro selected certain financial ratios to value the Savings shares. Placing primary weight on the price-to-earnings ratio, secondary weight on the price-to-book ratio, and little weight on the dividend yield measure, Spiro concluded that the "indicated value" of a minority interest in Savings would be $369 per share, if the shares were liquid and freely traded.

Because the shares are not quickly convertible into cash, Spiro applied a liquidity discount to the indicated value.[15] To determine the size of the liquidity discount, Spiro considered several studies,[16] and reviewed 19

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[15] We note that in this case, a liquidity discount and a discount for lack of marketability are conceptually indistinguishable.

[16] Spiro relied on the following studies: Pratt, "Discounts and Premia", Valuation of Closely Held Companies and Inactively Traded Securities (1990); Maher, "Discounts for Lack of Marketability for Closely Held Business Interests", 54 TAXES 562 (Sept. 1976); Moroney, "Most Courts Overvalue Closely Held Stocks", 51 TAXES 144 (Mar. 1973); Emory, "The Value of Marketability as Illustrated in Initial Public Offerings of Common Stock", Bus. Valuation Rev. (Dec. 1986); and Emory, "The Value of

opinions of this Court that were decided after 1983 in which we found a discount separately and specifically for either lack of marketability or restrictions on transfer with respect to a closely held company. The discounts in the studies and cases ranged from 10 to 45 percent. Spiro next considered the particular facts and circumstances of the Savings stock, including the existing market for the stock, the rising price trend of the traded shares, Savings' history of paying increasing dividends, and the lack of restrictions on trading the shares. Spiro concluded that a liquidity discount of 20 percent was appropriate and that under the market method the fair market value of the stock was $295.27 per share.

To incorporate the actual sales value into his analysis, and to reflect the amount of time it would take to sell a block of shares the size of petitioner's, Spiro assumed that the shareholder could go to a lender and hypothecate the block for a loan. To repay the loan, the shareholder would sell the shares over the next 8 years and 3 months at a rate equal to the number of shares that were sold on average per month during the first 10 months of 1991. Spiro estimated the prices for which the shares would sell in future years by increasing the actual price at which decedent sold 1,111 shares in 1991 by a factor that was a conservative reflection of the historic growth rate of the stock's book value. In this calculation, Spiro included his estimation of the cash-flow from future dividends paid. Finally, Spiro assumed that the shareholder would pay 2 percentage points above the prime rate, which was 7.5 percent at

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Marketability as Illustrated in Initial Public Offerings of Common Stock (January 1994 through June 1995)", Bus. Valuation Rev. (Dec. 1995).

the date of valuation, for the loan. Therefore, he calculated the present value of the cash-flow from the stock sales and dividends using 9.5 percent as a discount factor.

Using this piecemeal sales method, Spiro concluded that the "implied price per share" was $308. This amount represents an illiquid minority value and requires no further adjustment.

To value the shares by the income method, Spiro capitalized Savings' 1992 pro forma cash-flow. To make this determination, Spiro made certain assumptions regarding Savings' 1992 net interest income, provision for loan losses, other operating income and expenses, income taxes, and additions to equity capital. Spiro developed the discount rate he used to calculate the present value of the estimated cash-flow by reducing the rate of return that he thought an equity investor in Savings would require by 7 percent, his estimate of Savings' long- term growth rate.

Using this method, Spiro concluded that the minority value of the stock was $331 per share, before considering a liquidity discount. After applying the 20-percent liquidity discount, Spiro concluded that the fair market value of the stock was $266 per share.

To reconcile the results of the different methods, Spiro calculated the weighted average of the different values. Spiro assigned the results of the piecemeal sales method 40 percent of the total, the market method 35 percent, and the income method 25 percent. Spiro concluded that the fair market values of petitioner's stock was $293 per share.

We reject part of respondent's expert's opinion and accept part. In the market method section of his

written report, Spiro stated that the "P/E ratio[17] is principally influenced by earnings growth, with higher-growth companies trading on average at higher P/E ratios." Spiro chose a price-to-earnings ratio for Savings by comparing Savings' 1-year and 3-year growth trends to the average of the selected companies' growth trends, and derived a share price of $373.41 from that ratio.

In analyzing the data Spiro used to derive this value, we find no statistically significant correlation between the seven selected companies' growth trends and their price-to-earnings ratios.[18] Using the average of these companies' growth trends to determine a price earnings multiple for Savings is akin to a navigator averaging compass points chosen at random to plot a course. We

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[17] Price-to-earnings ratio.

[18] The selected companies and their growth trends and price-to-earnings ratios are as follows:

	Growth Trends		
Company	1-Year	3-Year	P/E Ratios
California Bancshares, Inc.	-18.73	5.58	11.02
Civic Bancorp	-32.32	22.91	7.95
First Commercial Bancorp	-25.91	11.64	5.75
The Pacific Bank	2.11	-1.24	8.01
Redwood Empire Bankcorp	148.56	32.22	9.02
University National Bank	1.54	3.21	9.64
Westamerica Bancorporation	14.35	38.99	9.05

There is no significant correlation between the companies' growth rates and price-to-earnings ratios. Spiro's data does not support his premise that the price-to-earnings ratio is principally influenced by earnings growth, or that knowledge of a company's net income growth trend helps to predict its price-to-earnings ratio. See Freund & Smith, Statistics: A First Course, 441 (4th ed. 1986); Kroeber & LaForge, The Manager's Guide to Statistics and Quantitative Methods, 147-148 (1980).

reject this part of Spiro's opinion, because the data he used does not support his conclusion.

We reject Spiro's reliance on the restricted sales and IPO studies for the same reasons we have already expressed in addressing the opinion of petitioner's expert.

We do not agree with the implied share value that Spiro obtained using his piecemeal sales method. To calculate this value, Spiro assumed that a lender would make the same assumptions as he did regarding the future values of the shares, the amount of the dividends, and the number of shares that could be sold per year, and that the lender would make a loan equal to 100 percent of the present value of the future cash-flow, which would be secured in total only by the shares.

We think that a lender would require the entire block of stock as security for a loan equal to only a part of the stock's value;[19] therefore, a loan for the total amount of the value of the shares would, in part, have to be otherwise secured. The interest rate charged the borrower for the portion of the loan not secured by the Savings shares (the unsecured portion) would depend upon the creditworthiness of the borrower. The actual interest rate would thus be a weighted average of the rates charged for the secured and unsecured portions of the loan. Consequently, the actual interest rate would vary depending upon the creditworthiness of the particular borrower.

By using a valuation method that is dependent upon the interest rate available to a particular borrower,

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[19] Spiro conceded at trial that the stock would not secure the entire amount of the loan.

instead of the market rate of return required by investors in this type of security, Spiro calculated the value of the stock to a particular borrower, not the fair market value of the shares.

Finally, we disagree with Spiro's estimate of the amount of time it would take to dispose of the shares for the same reason we disagreed with petitioner's estimate.[20]

We think that the actual sales value of the 1,111 shares sold at arm's length to unrelated parties 1 month before decedent's death provides the best indication of the value of the shares. The price at which these shares sold reflects the market's appreciation of the value of a minority interest in Savings stock and its awareness of the stock's limited marketability.

Moreover, no evidence was offered of any change in the market conditions, the constraints of the economy, or the financial condition of Savings between the date of decedent's sale of 1,111 shares and the date of petitioner's sale of 2,800 shares that would have affected the demand for the shares. Thus, the fact that decedent's block of shares sold quickly once it was offered, and that approximately 10 months later petitioner's larger block of shares sold equally quickly, indicates that the market for Savings' shares is considerably more liquid than either petitioner or respondent opined.

However, although Mannon testified that after petitioner's sale some of the buyers expressed an interest in purchasing more shares, he also testified that others could have bought no more. Furthermore,

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[20] Spiro noted in his written report that his estimate is "conservative in light of the fact that [petitioner] sold * * * 2,800 shares in 1992".

although the blocks of stock sold by decedent and petitioner sold quickly and the shares in petitioner's sale sold for a higher price than the shares in decedent's earlier sale, the amount by which the actual sales price exceeded book value was slightly less in the later sale than in the earlier sale.[21] Therefore, the number of Savings shares that can be sold without affecting price is uncertain, but not unlimited.

The facts and circumstances of this case indicate that a 10-percent discount for blockage is appropriate. Accordingly, we find that the fair market value of petitioner's Savings stock is $276 per share.

Issue 2. Fair Market Value of the Willits Shares

Respondent determined that the value of petitioner's Willits stock was $850 per share; however, he now contends that the date-of-death fair market value of petitioner's Willits stock is $774 per share. Respondent bases his contention on the results of petitioner's sale of all its shares approximately 9 months after decedent's death.

Petitioner asserts that the value of the stock is $485 per share, but concedes on brief that the evidence supports a valuation in the range of $485 to $662 per share. Petitioner further asserts that the sales history of Willits' stock is evidence that there is no market for the shares, and that the price it received for the shares is not representative of their fair market value because the shares were not sold at arm's length.

Petitioner sold its 500 shares of Willits stock for $850 per share; 365 of the shares were purchased by

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[21] Decedent sold 1,111 shares at 8.31 percent above book value; petitioner sold 2,800 shares at 4.12 percent above book value.

Mannon. At the time he purchased the shares, Mannon owned more than 30 percent of Willits' outstanding shares, and was a director and chairman of the board of Willits, March's cousin, and decedent's nephew. Mannon testified that he bought the shares even though he did not want them, because March was a family member, the estate taxes were due, and he could not find another buyer.

We previously have held that "Forced sales of stock to family members to enable them to pay estate taxes are in no way reflective of fair market value because the sales occurred under unusual circumstances." See *Estate of Oman v. Commissioner*, T.C. Memo. 1987-71; see also *Estate of Miller v. Commissioner*, T.C. Memo. 1959-235. Considering the relationship of the parties and petitioner's need for funds to pay the estate taxes, we find that Mannon was an accommodating buyer, not a willing buyer. Therefore, we do not consider the sale to Mannon in deciding the fair market value of petitioner's shares.

However, at the time petitioner sold the shares to Mannon, petitioner also sold 125 shares to Bozarth and 10 shares to Brown. Bozarth is a director of Willits and Brown is an executive officer; both had their positions with Willits and were shareholders before they purchased these shares. Furthermore, neither one has any relationship with either petitioner or March. We consider the price Bozarth and Brown paid evidence of the value of a minority interest in Willits.

Petitioner argues that a discount is warranted for the "gloomy state" of the 1991 economy, Willits' past history of economic loss, the absence of any real market for the shares, and the extended holding period re-

quired to dispose of petitioner's block. Only petitioner's last two assertions have any basis in fact.

Willits' 1991 annual report to shareholders stated that it "will show a sizeable increase in profits" even though the "economy was such that the increase in deposits was very meager." In fact, Willits showed a 15-percent increase in net income compared to 1990. Thus, Willits appeared to be weathering the gloomy state of the economy rather well.

Furthermore, petitioner's assertion that Willits has a history of economic loss is not supported by the record. Mannon testified that he thought Willits actually may have suffered a negative income year in either 1981 or 1982, but that Willits performed well in the late 1980's. We do not find Mannon's testimony supports a finding that Willits has a history of loss, and petitioner offered no other evidence to support this assertion. Accordingly, we do not consider either of these assertions in deciding the value of petitioner's shares.

Both sides submitted expert witness reports and presented expert witness testimony in regard to the value of decedent's shares of Willits stock at the date of death.

Petitioner's Expert's Opinion

Petitioner's expert is Jeffrey T. Tarbell (Tarbell). Tarbell is a senior associate of Willamette Management Associates, and was a qualified expert at the time he prepared his report. Tarbell's testimony at trial was cryptic and unhelpful; we, therefore, rely upon only the written report for his opinion. Tarbell did not consider petitioner's sale of its stock in his analysis.

Tarbell selected nine publicly traded banks comparable to Willits as guideline companies and used the

market method to value the Willits shares. Tarbell compared Willits' earnings per share for the last 12 months to the guideline companies' earnings per share for the same period, and selected four companies that had earnings growth rates similar to Willits. Using the companies' ratios for guidance, Tarbell selected a multiple to apply to Willits' earnings per share, and derived an indicated value of $902 per share. He repeated the same process with Willits' 5-year average earnings per share, and derived an indicated value of $945 per share.

Tarbell compared the guideline companies' dividend payout ratios to their dividend yields. He found that there was a relationship between the payout ratios and the dividend yields, and that the companies with higher payout ratios have higher dividend yields. Tarbell selected one company from the guideline companies that had a payout ratio and an increase in its 12-month earnings similar to those of Willits, and applied its dividend yield rate to Willits' current dividend. This process produced an indicated value of $788 per share.

Tarbell analyzed the price-to-book value ratios and the current returns on equity of the guideline companies and found that there was a strong relationship between the ratios. He selected two companies that had returns on book value similar to Willits and determined that a multiple of 1.10 was appropriate to apply to Willits' book value. This process resulted in an indicated value of $887 per share.

Finally, Tarbell weighted the indicated values derived from the various valuation methods according to his opinion of their relative significance and concluded that the publicly traded minority value of Willits stock was $882 per share, before considering a discount for lack of marketability.

Tarbell opined that a 45-percent discount for lack of marketability was appropriate due to the limited market for Willits stock and the size of petitioner's block, and concluded that the fair market value of the stock was $485 per share. Petitioner's report does not state separately the amounts of the limited market and blockage components of the discount.

Tarbell cited the usual restricted stock and IPO studies,[22] and Rev. Rul. 77-287, 1977-2 C.B. 319, to support his opinion of the discount. Rev. Rul 77-287, *supra*, sets forth guidelines for valuing securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities law.

The Willits shares are not restricted from trading by either law or agreement. Petitioner offered no evidence of any shareholders who were unable to sell their shares once offered for sale. Therefore, there is no evidence that the low trading volume is due to any reason other than the shareholder's preference to hold the shares for long-term investment, rather than sale. Accordingly, we find no persuasive evidence in the

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[22] In addition to the Emory IPO studies earlier cited by Gasiorowski and Spiro, see *supra* notes 9 and 16, Tarbell cited the following restricted stock studies: Gelman, "An Economist-Financial Analyst's Approach to Valuing Stock of a Closely Held Company", 36 J. Taxn. 353 (June 1972); Moroney, "Most Courts Overvalue Closely Held Stocks", 51 TAXES 144 (Mar. 1973); Moroney, "Why 25 Percent Discount for Nonmarketability in One Valuation, 100 Percent in Another?", 55 TAXES 316 (May 1977); Maher, "Discounts for Lack of Marketability for Closely Held Business Interests", 54 TAXES 562 (Sept. 1976); Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities", 55 TAXES 381 (June 1977); "Revenue Ruling 77-287 Revisited," SRC Quarterly Reports (Spring 1983); Bolten, "Discounts for the Stocks of Closely Held Corporations", 123 Trs. & Ests. 22 (Dec. 1984).

record to justify reliance on the restricted stock studies in determining an appropriate marketability discount.

Furthermore, in considering the trading history of the shares, Tarbell did not consider petitioner's arm's-length sale of approximately 1.69 percent[23] of Willits' issued and outstanding shares at a price near book value to unrelated parties less than 10 months after decedent's death. Therefore, Tarbell did not consider all the evidence relevant to deciding the size of the discount. Accordingly, we give little weight to this portion of petitioner's opinion.

Respondent's Expert's Opinion

Respondent's expert is Spiro. In his report, Spiro used the market and income methods and considered the actual sales to value petitioner's Willits shares. Spiro ultimately concluded that the fair market value of the stock was $774 per share.

Spiro found five publicly traded bank companies that were sufficiently comparable to Willits to use as guideline companies for the market method of valuation. Employing the same methodology that he used to value the Savings shares, Spiro selected certain financial ratios to value the Willits shares. Weighting the price-to-earnings ratio 50 percent, the price-to-book ratio 40 percent, and the dividend yield measure 10 percent, Spiro derived an indicated value of $944 per share for a minority interest in Willits, if the shares were liquid and freely traded.

Spiro applied a liquidity discount to the indicated value. To determine the size of the discount, Spiro relied on the same studies and opinions that he relied

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[23] This amount does not include the 365 shares sold to Mannon.

upon in determining the size of the discount to apply to the Savings stock. He also considered the particular facts and circumstances of the Willits stock, including the level of Willits' public recognition in the local community, its history of paying increasing dividends, the lack of restrictions on trading the shares, the existing market for the stock, and the stock's trading history. Spiro concluded that a liquidity discount of 20 percent was appropriate, and that the fair market value of the stock was $755 per share.

Spiro used his piecemeal sales method to estimate the present value of the Willits shares in the same way that he used it to estimate the value of the Savings shares, except he assumed that 125 Willits shares could be sold each year for the next 4 years at a price approximating their book value at the time of sale. Using this method, Spiro concluded that the implied price per share was $816.

To value the shares by the income method, Spiro capitalized Willits' pro forma cash-flow. To calculate the pro forma cash-flow, Spiro made certain assumptions regarding Willits' 1992 net income, provision for loan losses, other operating income and expenses, income taxes, and additions to equity capital. He developed the discount rate to calculate the present value of the pro forma cash-flow by reducing the rate of return that he thought an equity investor in Willits would require by 7 percent, his estimate of Willits' long-term growth rate.

Using this method, Spiro concluded that the minority value of the stock was $952 per share, before considering a liquidity discount. After applying the 20-percent liquidity discount, Spiro concluded that the fair market value of the stock was $732 per share.

To reconcile the results of the different methods, Spiro weighted the results of the piecemeal sales method 40 percent, the market method 35 percent, and the income method 25 percent, and concluded that the fair market value of the stock was $774 per share.

We accept part of respondent's expert's opinion and reject part. We reject the portion of the market method analysis in which Spiro calculated Willits' price-to-earnings multiple from the guideline companies' multiples because there is no statistically significant correlation between the selected companies' net income growth trends and their price-to-earnings multiples.[24]

In deciding the size of the discount, Spiro reviewed the conclusions of restricted stock and IPO studies, and considered the facts and circumstances of the Willits stock. We find no persuasive evidence in the record to support reliance on the restricted stock studies in determining an appropriate marketability discount.

In considering the particular facts and circumstances of the stock, Spiro found that Willits' publication of its annual report addressed to shareholders and other constituents is evidence that Willits has a high level of public recognition. We do not find that publishing its

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[24] The selected companies and their growth trends and price-to-earnings ratios are as follows:

	Growth Trends		
Company	1-Year	3-Year	P/E Ratios
Redwood Empire Bankcorp	148.56	32.22	9.02
First Commercial Bancorp	-25.91	11.64	5.75
Civic Bancorp	-32.32	22.91	7.95
California Bancshares, Inc.	-18.73	5.58	11.02
University National Bank	1.54	3.21	9.64

annual report supports a finding that Willits enjoyed a high level of public recognition.

Spiro concluded that there was an established market for the shares. The trading history of Willits stock does not support this conclusion. The evidence shows that except for decedent's sales, few shares were traded on an occasional basis, and most of the transactions were between family members, and Willits' directors, officers, and employees. We accord this part of Spiro's opinion little weight.

Finally, we reject the value Spiro obtained with his piecemeal sales method, because we think the method results in the value of the stock to a particular borrower, not the fair market value.

We think that petitioner's sale of 135 shares at arm's length to unrelated parties after decedent's death provides the best indication of the value of a minority interest in Willits. In this transaction, the shares were purchased by persons whom we presume have knowledge of the limits of the market and the value of a minority interest in Willits.

Moreover, Willits shares have historically traded at or near book value. In petitioner's sale, the shares sold for approximately 2.9 percent less than their book value at the time of sale. The book value provided this Court nearest the date of valuation was $806. Accordingly, we find that the value of a minority interest on the date of valuation was $783, before applying a discount for blockage.

The market for the Willits' shares was limited, and petitioner could not have sold its block of shares in a reasonable period of time without depressing the market and lowering the price. Accordingly, we apply a 20-

percent discount for blockage and find that the fair market value of the Willits stock is $626 per share.

Issue 3. Whether Petitioner May Deduct the Expense of Defending Its Reporting Position

Petitioner asserts by amended petition that certain expenses it incurred defending its reporting position with regard to the value of the Savings and Willits shares are administration expenses deductible from the value of the gross estate. Respondent did not address this issue at trial or on brief.

Section 2053(a)(2) provides that administration expenses shall be deducted from the value of the gross estate if they are allowable by the law of the jurisdiction under which the estate is being administered. Administration expenses include attorney's fees and miscellaneous expenses. See sec. 20.2053-3(a), Estate Tax Regs. Miscellaneous administration expenses include accountant's fees and appraiser's fees. See sec. 20.2053-3(d)(1), Estate Tax Regs. The amounts deductible as administration expenses are limited to such expenses as are actually and necessarily incurred in the administration of the decedent's estate. See sec. 20.2053-3(a), Estate Tax Regs. However, expenditures not essential to the proper settlement of the estate but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. See *id.* Attorney's fees incurred by beneficiaries incident to litigation as to their respective interests are not deductible if the litigation is not essential to the proper settlement of the estate. See sec. 20.2053-3(c)(3), Estate Tax Regs.

California law allows the personal representative to employ tax experts in negotiations or litigation that

may be necessary for the final determination and payment of taxes and to pay the experts from the funds of the estate.[25] The litigation undertaken by petitioner in this case was in response to respondent's determination of a deficiency in petitioner's Federal estate tax. The litigation did not relate to the respective interests of the heirs, nor was it incurred for their individual benefit. Accordingly, we conclude that the administrative expenses petitioner claims are of the type that are allowable under California law and the regulations.

Respondent's regulations provide that a deduction for attorney's fees incurred in contesting an asserted deficiency or in prosecuting a claim for refund should be claimed at the time the deficiency is contested or the refund claim is prosecuted. See sec. 20.2053-3(c)(2), Estate Tax Regs. Furthermore, a deduction for these fees shall not be denied, and the sufficiency of a claim for refund shall not be questioned, solely by reason of the fact that the amount of the fees to be paid was not established at the time that the right to the deduction was claimed. See *id.*

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[25] California law provides:

> The personal representative may also employ or retain tax counsel, tax auditors, accountants, or other tax experts for the performance of any action which such persons, respectively, may lawfully perform in the computation, reporting, or making of tax returns, or in negotiations or litigation which may be necessary for the final determination and payment of taxes, and pay from the funds of the estate for such services. [Cal. Prob. Code Ann. sec. 10801(b) (West 1998).]

These amounts are in addition to the compensation allowed under Sec. 10800 for all ordinary services of the personal representative. See Cal. Prob. Code Ann. sec. 10801(a) (West 1998).

Petitioner has met the requirements for claiming the deductions. Petitioner paid $21,226 of attorney's fees, $8,830 of accountant's fees, and $12,396 of appraisal costs to defend its reporting position in an audit by the Internal Revenue Service. Petitioner filed Form 843, Claim for Refund and Request for Abatement, to claim a refund of the estate tax paid on these amounts soon after filing its petition in this case. At that time, petitioner also filed a protective claim for refund of estate tax for additional administration expenses that it expects to incur in further defending its position.

Respondent did not address this issue either at trial or on brief. Accordingly, we find that petitioner may deduct the reasonable administration expenses incurred in settlement of the estate.

To reflect the foregoing,

Decision will be entered under Rule 155.

APPENDIX C

UNITED STATES TAX COURT

No. 10028-95

ESTATE OF FRANK BRANSON, DECEASED; MARY M. MARCH, EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

July 13, 1999

OPINION

PARR, J.

P reported the date-of-death fair market values of the stock of S and W as $181.50 and $485, respectively, per share. P sold some of the S stock for $335 per share and all the W stock for $850 per share. The gain realized on the sales by P was distributed to the residuary legatee, M, who reported the gain on her Federal income tax return and paid the income tax due. R determined a deficiency in P's estate tax liability R's determination was based on his assertion that at the date of death the fair market values of the S and W shares were $300 and $850, respectively, per share. In *Estate of Branson v. Commissioner*, T.C. Memo.1999-231, we found that the date-of-death fair market values of the S and W shares were $276 and $626, respectively. P asserts that it is entitled to equitable recoupment of

the income tax overpaid by M, the refund of which is barred by the statute of limitations.

Held, under the doctrine of equitable recoupment, P is entitled to a credit for the income tax overpaid by M on the gain recognized on the sales of the shares due to the lower values reported on the estate tax return. *Estate of Bartels v. Commissioner*, 106 T.C. 430 (1996); *Estate of Mueller v. Commissioner*, 101 T.C. 551 (1993), followed.

In *Estate of Branson v. Commissioner*, T.C. Memo. 1999-231 (Branson I), we redetermined the increased value of the shares of Savings Bank of Mendocino County (Savings) and Bank of Willits (Willits) included in decedent's gross estate. We now consider whether this Court has authority to apply equitable recoupment in light of the opinion of the Court of Appeals for the Sixth Circuit in *Estate of Mueller v. Commissioner*, 153 F.3d 302 (6th Cir. 1998), affg. on other grounds 107 T.C. 189 (1996), and if so, whether petitioner is entitled under that doctrine to credit for the taxes paid by the residuary legatee on the excessive gain recognized from the sales of the shares due to the lower values provided by the estate tax return. Following our opinions in *Estate of Bartels v. Commissioner*, 106 T.C. 430 (1996), and *Estate of Mueller v. Commissioner*, 101 T.C. 551 (1993), we hold that this Court has authority to apply equitable recoupment. We further hold that petitioner is entitled to recoup the residuary legatee's excessive payment of income tax against the estate tax deficiency.

The relevant facts are taken from our findings in Branson I, the parties' submissions, and the existing record. Petitioner is the estate of Frank A. Branson (decedent), who died testate on November 9, 1991, in

Mendocino, California. Mary March (March), decedent's daughter, is the executrix and residuary legatee of the estate. March's legal address was Potter Valley, California, at the time the petition in this case was filed.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect as of the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure. All dollar amounts are rounded to the nearest dollar, unless otherwise indicated.

Background

At the time of his death, decedent owned 12,889 shares of Savings stock and 500 shares of Willits stock. Petitioner reported the value of the Savings and Willits shares as $181.50 and $485, respectively, per share, on its Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return.

Decedent's will provided that all estate taxes were to be paid from the residue of the estate. Pursuant to a court order, March, as executrix, was granted authority to sell 2,800 shares of Savings stock at $335 per share and 500 shares of Willits stock at $850 per share. March sold the shares in 1992 and paid Federal and State of California estate taxes of $1,008,698 and $200,632, respectively. March, as executrix and residuary legatee, assumed individual liability for any estate taxes later found due from petitioner.

Petitioner reported the capital gain from the sales of the Savings and Willits shares on Schedule D of its 1992 Form 1041, U.S. Fiduciary Income Tax Return, which it filed on or about April 15, 1993. Petitioner calculated the gain by subtracting the value of the shares reported on the estate tax return from the amount received from

their sale. Petitioner reported $429,800 of gain from the sale of the Savings shares and $182,500 from the sale of the Willits shares.[1] Petitioner, however, did not pay any income tax on these gains; instead, it reported a net long-term capital gain distribution of $610,274 to March on Schedule K-1, Beneficiary's Share of Income, Deductions, Credits, Etc., which it attached to the Form 1041.

March and her husband, Charles March, filed their 1992 Form 1040, U.S. Individual Income Tax Return, using the status of "Married filing joint return", on or about April 15, 1993, and paid the tax due. March reported the $610,274 gain on line 13 of Schedule D, which was attached to the Form 1040, as "Net long-term gain or (loss) from partnerships, S corporations, and fiduciaries".

Respondent determined a deficiency in petitioner's estate tax liability on the grounds that the fair market values of the Savings and Willits on the date of death were $300 and $850, respectively, per share. In Branson I, we found that the date-of-death fair market values of the Savings and Willits shares were $276 and $626, respectively. Petitioner asserts that it is entitled to equitable recoupment of the income tax overpaid by March, the refund of which is barred by the statute of limitations, in determining the amount of its Federal estate tax liability.

Discussion

Relying upon *Estate of Mueller v. Commissioner*, 153 F.3d 302 (6th Cir. 1998), respondent asserts that this

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[1] Petitioner also reported $6,955 of long-term capital gain from the sale of 2,000 shares of PG & E stock and a $738 net long-term capital loss carryover from 1991. The value of the PG & E shares and the loss carryover are not at issue in this case.

Court lacks jurisdiction to consider petitioner's claim for equitable recoupment. In *Estate of Mueller v. Commissioner*, 101 T.C. 551 (1993) (Mueller II), we opined that we have jurisdiction to consider claims of equitable recoupment. In *Estate of Mueller v. Commissioner*, 107 T.C. 189 (1996) (Mueller III), we held that equitable recoupment is restricted to use as a defense against an otherwise valid claim. As a result of our valuation of the stock includable in Mueller's estate, see *Estate of Mueller v. Commissioner*, T.C. Memo. 1992-284, and the taxpayer's failure to claim a large previously taxed property credit on its Federal estate tax return, it became apparent that there was no deficiency in estate tax; rather, the taxpayer was entitled to recover an overpayment of estate tax, regardless of equitable recoupment, Inasmuch as application of equitable recoupment under these circumstances would have increased the amount the taxpayer was entitled to recover as an overpayment, rather than reduce a deficiency, we held that equitable recoupment was not available. The taxpayer appealed. The Court of Appeals for the Sixth Circuit affirmed Mueller III, on the ground that this Court lacked jurisdiction to consider the affirmative defense of equitable recoupment. See *Estate of Mueller v. Commissioner, supra.*

The Court of Appeals for the Sixth Circuit interpreted sections 6214(b) and 6512(b) together to

> explicitly confer on the Tax Court jurisdiction to do no more than determine the amount of the deficiency before it. The Tax Court's jurisdiction cannot extend beyond its statutory confines to encompass an equitable remedy such as recoupment because the Tax Court "is a court of limited jurisdiction and lacks general equitable powers," and because "[t]he

> Tax Court and its divisions shall have such jurisdiction as is conferred on on them by [Title 26]." * * * [*Estate of Mueller v. Commissioner*, 153 F.3d at 305; citations omitted.]

The Court of Appeals further relied upon *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943), and several cases decided in Federal courts which have cited *Gooch Milling*,[2] for the proposition that this Court does not have jurisdiction to consider the affirmative defense of equitable recoupment.

The jurisdictional status of equitable recoupment in this Court has had a long history, which we reviewed with painstaking care in *Estate of Bartels v. Commissioner*, 106 T.C. 430 (1996) and in Mueller II. We do not here reiterate that history, except to distinguish our position from that of the Court of Appeals for the Sixth Circuit.

In Mueller II, we interpreted *Commissioner v. Gooch Milling & Elevator Co., supra*, as presenting the question whether the Board of Tax Appeals had authority to apply the doctrine of equitable recoupment in income tax cases. We concluded that *Gooch Milling* does not prevent this Court from "considering the affirmative defense of equitable recoupment when it is properly raised in a timely suit for redetermination of a tax deficiency over which we have jurisdiction." See Mueller II, 101 T.C. at 560.

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[2] See *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 303 (1946); *Elbert v. Johnson*, 164 F.2d 421, 424 (2d Cir. 1947); *Mohawk Petroleum Co. v. Commissioner*, 148 F.2d 957, 959 (9th Cir. 1945), affg. 47 B.T.A. 952 (1942); *Estate of Van Winkle v. Commissioner*, 51 T.C. 994, 999 (1969); *Wiener Mach. Co. v. Commissioner*, 16 T.C. 48, 54 (1951).

In its opinion, the Court of Appeals for the Sixth Circuit did not consider the difference between the Board of Tax Appeals and the Tax Court. At the time the Board of Tax Appeals decided the issue of whether it could consider equitable recoupment in *Gooch Milling & Elevator Co.*, the Board was an independent agency in the Executive Branch of the Governn.ent. See sec. 900 (k) of the Revenue Act of 1924, ch. 234, 43 Stat. 253, 338. As a result of the Tax Reform Act of 1969, Pub. L. 91-172, sec. 951, 83 Stat. 487, 730, the Tax Court became a legislative court under Article I of the Constitution. See sec. 7441; *Freytag v. Commissioner*, 501 U.S. 868, 887 (1991) (Congress enacted legislation in 1969 with the express purpose of making the Tax Court an Article I court rather than an executive agency). Thus, the Tax Court exercises judicial, rather than executive, legislative, or administrative, power. See *Freytag v. Commissioner*, *supra* at 890-891.

The difference between an agency of the Executive Branch and an Article I court is material to this issue. "The Tax Court's function and role in the federal judicial scheme closely resemble those of the federal district courts, * * * [and it] exercises its judicial power in much the same way as the federal district courts exercise theirs." *Freytag v. Commissioner*, *supra* at 891.[3] Moreover, in deciding cases over which we have jurisdiction "we have applied the equity-based principles of waiver, duty of consistency, estoppel, substantial compliance, abuse of discretion, laches, and the tax benefit rule." See *Woods v. Commissioner*, 92

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[3] See also *Flight Attendants Against UAL Offset v. Commissioner*, 165 F.3d 572, 578 (7th Cir. 1999) ("the present Tax Court operates pretty indistinguishably from a federal district court.").

T.C. 776, 784 (1989); fn. refs. omitted. Thus, this Court should be properly viewed as exercising full judicial power within its limited subject matter jurisdiction.[4]

Furthermore, in *United States v. Dalm*, 494 U.S. 596, 611 n.8 (1990), the Supreme Court noted: "We have no occasion to pass upon the question whether Dalm could have raised a recoupment claim in the Tax Court." See also *id.* at 615 n.3 (Stevens, J., dissenting) (commending the majority's reservation of the question whether the Tax Court has authority to consider recoupment). Thus, although the Supreme Court agreed that the Board of Tax Appeals could not consider equitable recoupment, we believe that the Supreme Court has left this issue open with respect to the Tax Court as presently constituted. *Commissioner v. Gooch Milling & Elevator Co* ., and its progeny, therefore, do not control the outcome of this case.

We have found support for our holding that we have authority to apply equitable recoupment in section 6214(b).[5] The concluding language of section 6214(b), which speaks in terms of this Court's not having "jurisdiction *to determine* whether or not *the tax* for

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[4] See Saltzman, IRS Practice and Procedure, par. 5.06[1], at S5-20 (2d ed.1991); Willis, "Equitable Recoupment: More Pitfalls for the Unwary", Tax Notes 361 (Oct. 19, 1998).

[5] Sec. 6214(b) provides:

> The Tax Court in redetermining a deficiency of income tax for any taxable year or of gift tax for any calendar year or calendar quarter shall consider such facts with relation to the taxes for other years or calendar quarters as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other year or calendar quarter has been overpaid or underpaid.

any other year or calendar quarter has been overpaid or underpaid" (emphasis added), means that, at most, we are precluded from determining the income tax or gift tax for any prior period. See *Estate of Bartels v. Commissioner*, 106 T.C. at 434. In redetermining the amount of the estate tax deficiency in this case, we are not determining the amount of income tax or gift tax deficiency or overpayment from any prior period. See *id.* We are considering such facts with relation to the share value included in both corpus and income so that this item[6] may be examined in all its aspects, as is necessary to correctly redetermine the amount of the estate tax deficiency now before us.[7]

In *Estate of Bartels v. Commissioner*, *supra* at 435-436, we stated:

> what is involved herein is a question of our authority and not a question of our jurisdiction since we already have jurisdiction by virtue of the income tax deficiency notice and the timely petition filed in response thereto. Thus, the cases articulating a principle that the jurisdiction of this Court is limited to that conferred upon it by *Congress* represented by *Commissioner v. Gooch Milling & Elevator Co.*, *supra*, and its progeny, have no application. * * * [Citation omitted.]

Therefore, "'While we cannot expand our jurisdiction through equitable principles, we can apply equitable principles in the disposition of cases that come within our jurisdiction.'" See *Woods v. Commissioner*, *supra*

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[6] See *infra* pp. 17-18.

[7] Furthermore, sec. 6214(b) specifically applies only to income and gift taxes, and makes no mention of estate tax. See *Estate of Mueller v. Commissioner*, 101 T.C. 551, 560 (1993).

at 784-785 (quoting *Berkery v.. Commissioner*, 90 T.C. 259, 270 (1988) (Hamblen, J., concurring)).

In this case, respondent accepted petitioner's and March's income tax returns, which reported gain calculated by using the fair market values of the shares reported on the estate tax return. Respondent asserted a higher date-of-death fair market value for those same shares for estate tax purposes, determined a deficiency in petitioner's estate tax, and issued a statutory notice of deficiency. In response, petitioner filed its timely petition with this Court. There is no doubt that we have jurisdiction of this case. We may therefore exercise full judicial power in its disposition.

Court of Appeals for the Ninth Circuit

Any appeal in this case lies to the Court of Appeals for the Ninth Circuit, and we are bound by any decision of that court squarely in point. See *Golsen v. Commissioner*, 54 T.C. 742, 756-757 (1970), affd. 445 F.2d 985 (10th Cir. 1971). Respondent asserts that this issue was settled in the Ninth Circuit by *Mohawk Petroleum Co. v. Commissioner*, 148 F.2d 957, 959 (9th Cir. 1945), affg. 47 B.T.A. 952 (1942).

In *Mohawk Petroleum Co. v. Commissioner, supra*, the Court of Appeals relied on *Gooch Milling & Elevator Co.* for its decision that the Board of Tax Appeals lacked jurisdiction to consider equitable recoupment of income taxes. See *id.* at 959. Because we have found that *Gooch Milling & Elevator Co.* is not on point, it follows that *Mohawk Petroleum Co.* is not dispositive. Accordingly, we disagree with respondent's assertion.

In Mueller II, we found additional support for our decision in sections 7422(e), 6512(a), and 7481. See Mueller II, 101 T.C. at 557. Considered together, these

sections indicate that "Congress intended the Tax Court to have full judicial authority to resolve issues over which it has jurisdiction". *Woods v. Commissioner*, 92 T.C. at 788. Judge Halpern further observed that

> the Code is structured to channel tax litigation to the Tax Court. We are the tax forum of choice, because only here can the tax liability be litigated prior to payment. Understandably, we preside over the vast majority of tax litigation. * * * [Mueller II, 101 T.C. at 564 (Halpern, J., concurring); citations omitted.]

If this Court lacked authority to consider equitable recoupment, a taxpayer without the practical ability to prepay the contested deficiency and sue for refund in a different forum would be precluded from raising a defense available to a more affluent taxpayer who has the means to do so. We do not believe that Congress intended this result. Accordingly, we shall continue to follow our opinions in *Estate of Bartels v. Commissioner*, 106 T.C. 430 (1996), and Mueller II, *supra*.

Defensive Use

We held in Mueller III that equitable recoupment is restricted to use as a defense against an otherwise valid claim for a deficiency, and not to increase an overpayment of tax. See also *United States v. Dalm*, 494 U.S. at 608 (tax refund courts are without jurisdiction to consider time-barred refund claims based solely upon equitable recoupment). We have found that petitioner underreported the values of the Savings and Willits shares on its estate tax return. Accordingly, petitioner has a deficiency in estate tax, and is, therefore, properly positioned to invoke the doctrine of equitable recoup-

ment to reduce that deficiency by the amount of the income tax overpaid because of its use of the same underreported value as the basis of the shares.

Legatee Not Diligent

Respondent argues that equitable recoupment should not be permitted in this case because March was not diligent in seeking a refund of the income tax paid on the gain passed through to her as residual legatee. The estate tax notice of deficiency was issued on March 16, 1995, and the limitations period did not expire on March's income tax refund until April 15, 1996. March thus had more than a year within which to file a protective claim for refund.

In addressing this issue in *United States v. Bowcut*, 287 F.2d 654, 657 (9th Cir. 1961), the Court of Appeals for the Ninth Circuit, citing *Bull v. United States*, 295 U.S. 247 (1935), stated:

> It is apparently not the diligence of the taxpayer as to his legal rights which controls, but rather the inequity of holding that, while the government's rights under a transaction continue unimpaired, its adversary's rights thereunder are barred by limitations.

Accordingly, we do not consider March's lack of diligence to be a factor in deciding whether petitioner is entitled to claim equitable recoupment.

Requirements of Equitable Recoupment

In a recent case, the Supreme Court reaffirmed that a party litigating a tax claim in a timely proceeding may, in that proceeding, seek recoupment of a related, and inconsistent, but now time-barred tax claim relating to the same transaction. See *United States v.*

Dalm, supra at 608 (interpreting *Bull v. United States*, 295 U.S. 247 (1935), and *Stone v. White*, 301 U.S. 532 (1937)).

A claim of equitable recoupment requires: (1) That the refund or deficiency for which recoupment is sought by way of offset be barred by time; (2) that the time-barred offset arise out of the same transaction, item, or taxable event as the overpayment or deficiency before the Court; (3) that the transaction, item, or taxable event have been inconsistently subjected to two taxes; and (4) that if the subject transaction, item, or taxable event involves two or more taxpayers, there be sufficient identity of interest between the taxpayers subject to the two taxes so that the taxpayers should be treated as one. See *United States v. Dalm, supra* at 604-605 & n.5; *Coohey v. United States*, 172 F.3d 1060 (8th Cir. 1999); *Parker v. United States*, 110 F.3d 678, 682- 683 (9th Cir. 1997).

Each of these requirements is met in the instant case.

1. *Refund Time-Barred*

March filed her 1992 Federal income tax return on or about April 15, 1993, and payment was made on the same date that the return was filed. March has never filed a claim for refund; therefore, a claim for refund is barred by section 6511(a).

2. *Single Transaction, Item, or Taxable Event*

Since *Bull v. United States, supra*, the Supreme Court has emphasized that a claim of equitable recoupment will lie only where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories. See *United States v. Dalm*, 494 U.S. at 608 n.5 (construing *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296, 299-300 (1946), *Bull*

v. United States, supra, and *Stone v. White, supra*). The terms "single transaction", "item", or "event" are not synonymous, and the inclusion of " item" in this phrase is significant in our case.

In *Bull v. United States, supra,* Archibald Bull (Bull) died owning a partnership interest, including the right to receive future profits. The partnership interest was transferred to his estate, and, later his estate received the sum of approximately $212,000, constituting its share of partnership profits earned subsequent to Bull's death. In 1921, the executor, at the Commissioner's insistence, erroneously included this sum in the gross estate under the theory that it was estate corpus, and thus, it was subjected to estate taxes. In 1925, the Government determined a deficiency in the estate's income tax on the correct theory that the same sum was income to the estate. The executor paid the income tax in 1928. Later, in that same year, the executor filed a claim for refund for the income tax paid and sued for refund after the claim was denied.

In considering the issue before it, the Supreme Court stated:

> A serious and difficult issue is raised by the claim that the same receipt has been made on the basis of both income and estate tax, although *the item* cannot in the circumstances be both income and corpus; and that the alternative prayer of the petition required the court to render a judgment which would redress the illegality and injustice resulting from the erroneous inclusion of *the sum* in the gross estate for estate tax. * * * [*Bull v. United States,* 295 U.S. at 255; emphasis added.]

The Supreme Court found that the estate's receipt of the sum was properly taxable as income to the estate and that under the facts of the case, "the item could not be both corpus and income of the estate." See *Bull v. United States*, *supra* at 258.

Thus, the Supreme Court viewed the sum of money owed to Bull's estate as an item. See *id.* at 255. We have no reason to believe that the same sum may be defined as an item for income tax purposes but be defined as something other than an item when included in corpus for purposes of calculating the estate tax. See *id.* at 256. In the case at hand, the same item (in terms of share value)[8] was included in both petitioner's corpus in determining the value of the gross estate and in income[9] Therefore, the estate tax and the income tax were imposed on the same item.

Furthermore, under the facts of the case before us, this item cannot properly be both corpus and income to the estate. The income tax paid by the residuary legatee on that identical item is money which the Government is not justly entitled to retain. See *id.* at 261 ("While here the money was taken through mistake

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[8] Petitioner reported the date-of-death fair market value of the Savings shares at $181.50 per share and used that amount as the basis in calculating the gain on the shares later sold. We have determined that the date-of-death fair market value of each Savings share is $276. Thus, $94.50 ($276 minus $181.50) of share value for each share of Savings stock was included in both corpus and income. Similarly, $141 ($626 minus $485) of share value for each share of Willits stock was included in both corpus and income.

[9] Petitioner sold the shares and calculated the amount of income (capital gain) realized from the sale. The income passed through the estate to March, who reported it on her return and paid the income tax due. Thus, although March recognized the income, it was realized by petitioner.

without any element of fraud, the unjust retention is immoral and amounts in law to a fraud on the taxpayer's rights.").

In holding that equitable recoupment was available for the taxpayer to credit the estate tax paid on the same item subjected to the income tax, the Supreme Court stated:

> This is because recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded. Such a defense is never barred by the statute of limitations so long as the main action itself is timely. [*Id.* at 262.]

Although the "single transaction" requirement was mentioned in *Bull v. United States, supra*, it was the stated ground for decision in *Rothensies v. Electric Storage Battery Co., supra*. In that case, the taxpayer erroneously paid excise taxes on the sale of electric storage batteries from April 1919 to April 1926. In July 1926, the taxpayer filed a claim for refund for the periods of mid-1922 to 1926, the years not barred by the statute of limitations, and received a refund in 1935. Although the taxpayer had been deducting the payment of these taxes, it did not include the refund in income. The Government determined a deficiency in the taxpayer's 1935 income tax, and the taxpayer paid the deficiency and sued for refund when its claim was denied.

In both the trial court and the Court of Appeals for the Third Circuit, the taxpayer asserted successfully that the income tax for 1935 should be reduced by equitable recoupment for the time-barred excise tax overpayments for the 1919 through mid-1922 years. In

affirming the District Court, the Court of Appeals for the Third Circuit stated that the same transaction element should be interpreted to mean that there be "a logical connection between main claim and the recoupment claim." *Electric Storage Battery Co. v. Rothensies*, 152 F.2d 521, 524 (3d Cir. 1945), revd. 329 U.S. 296 (1946).

In reversing on this issue, the Supreme Court stated that equitable recoupment

> has never been thought to allow one transaction to be offset against another, but only to permit a transaction which is made subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole. [*Rothensies v. Electric Storage Battery Co* ., 329 U.S. at 299.]

In *Rothensies v. Electric Storage Battery Co., supra*, it is clear that the case involved separate transactions, separate items, and separate taxable events; the time-barred overpayments arose from the erroneous treatment of many separate sales of batteries as subject to excise taxes,[10] and the income tax deficiency arose from the failure to include the refunded open-year excise taxes in gross income under the tax benefit rule.[11] The time- barred refunds of the 1919 through mid-1922 excise taxes and the inclusion of the refunded taxes that were paid in 1922 through 1926 in the

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[10] Therefore, the excise taxes paid in the time-barred years were not paid on the same item or in the same transaction, but on the same type of item or transaction.

[11] See Andrews, "Modern-Day Equitable Recoupment and the 'Two Tax Effect': Avoidance of the Statute of Limitation in Federal Tax Controversies", 28 Ariz. L. Rev. 595, 610 (1986).

taxpayer's 1935 income had no logical connection. The erroneous failure to include the excise tax refund in income for 1935 is not the same transaction as erroneously paying excise taxes in 1919 through mid-1922. Furthermore, there was no transactional nexus between the time-barred excise taxes paid in 1919 through mid-1922 and the refunded excise taxes paid in 1922 through 1926, which the taxpayer was required to include in income in 1935.

The Supreme Court has not decided a case based on the single-transaction requirement since *Rothensies v. Electric Storage Battery Co., supra.* In a recent case, *United States v. Dalm,* 494 U.S. 596 (1990), the Court held that equitable recoupment could only be used defensively, and the Court stated that since *Bull v. United States,* 295 U.S. 247 (1935), it has emphasized " that a claim of equitable recoupment will lie only where the Government has taxed a single transaction, item, or taxable event under two inconsistent theories." *United States v. Dalm, supra* at 605 n.5.

Consequently, the interpretation and application of the single-transaction requirement has been left to the lower courts, which has resulted in conflicting authority.

The cases on which petitioner mainly relies are *Boyle v. United States,* 355 F.2d 233 (3d Cir. 1965), revg. and remanding per curiam 232 F. Supp. 543 (D.N.J. 1964); *O'Brien v. United States,* 766 F.2d 1038 (7th Cir.1985), revg. 582 F. Supp. 203 (C.D. Ill. 1984); *Estate of Vitt v. United States,* 706 F.2d 871 (8th Cir. 1983); *United States v. Herring,* 240 F.2d 225 (4th Cir. 1957); and *United States v. Bowcut,* 287 F.2d 654 (9th Cir. 1961).

In *Boyle v. United States, supra*, the decedent died in 1953 owning preferred stock with more than 20 years of accumulated undeclared dividends (the arrearages). The decedent's assets were transferred to his estate, including the value of the arrearages, and the estate tax was paid accordingly. In 1954, the executors distributed the preferred stock among the four beneficiaries under the will.

Later, the beneficiaries, on receiving those arrearages, declared their receipt and listed them as nontaxable income on their tax returns. In 1958, after the period of limitations had expired to claim a refund of the estate taxes, the Government determined deficiencies in the beneficiaries' income tax because of their reporting position with respect to the dividends. The beneficiaries paid the income tax deficiencies and brought a suit for refund. The District Court denied them equitable recoupment against the time-barred estate tax, holding that the single-transaction test of *Rothensies v. Electric Storage Battery Co., supra*, was not satisfied. See *Boyle v. United States*, 232 F. Supp. at 549-550. The Court of Appeals for the Third Circuit reversed, finding that there was "double taxation of the single item" as both corpus and income, which sufficed to satisfy the requirements of *Bull v. United States*. See *Boyle v. United States*, 355 F.2d at 236.

The Court of Appeals distinguished *Rothensies v. Electric Storage Battery Co.*, on the grounds that in *Rothensies v. Electric Storage Battery Co.*, the taxpayer "waited over twenty years to seek a refund",[12]

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[12] Thus, the Court of Appeals for the Third Circuit indicated that in any equitable claim, an equitable defense, such as laches, may bar the claim.

and the facts in *Boyle* were much closer to the facts in *Bull* than were the circumstances of the taxpayer in *Rothensies v. Electric Storage Battery Co.* See *Boyle v. United States*, 355 F.2d at 236-237.

In *O'Brien v. United States, supra*, decedent's estate paid estate tax on the stock of a closely held corporation, which it valued at $215.7796 per share. In the year following the decedent's death, the Government determined a deficiency in the estate tax, asserting a higher value of the stock, and the taxpayer (one of decedent's heirs) filed a petition to the Tax Court. While the valuation issue was pending, the corporation was liquidated, and, for the purpose of calculating the resulting capital gain reportable on his income tax return, the taxpayer used the value of the shares reported on the estate tax return. The Government did not dispute this valuation and accepted the payment of income tax on the gain arising from the liquidation. In 1980, the Tax Court entered a stipulated decision in the estate tax case, setting the value of the stock at $280.10 per share. The taxpayer did not assert the equitable recoupment claim in the Tax Court case.

On April 8, 1981, the taxpayer filed a claim for refund for the income taxes that he overpaid in 1975 because of his use of the lower value as the stock's basis. The claim for refund was denied on the grounds that the period of limitations had run for the 1975 taxable year. The taxpayer then filed suit for refund in District Court, arguing that the basis for the stock should have been higher and using equitable recoupment as the ground for the suit.[13]

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[13] The taxpayer also argued for the refund under secs. 1311-1314, the statutory mitigation provisions. The District Court ac-

The District Court agreed, finding the single-transaction requirement satisfied. Like the Court of Appeals for the Third Circuit in *Boyle*, the District Court in *O'Brien* relied upon *Bull*, and found that the facts of *O'Brien* were closer to *Bull* than to *Rothensies v. Electric Storage Battery Co.* The Court of Appeals for the Seventh Circuit reversed, on the ground that equitable recoupment cannot be used offensively as an independent ground for reopening years closed by the statute of limitations. See *O'Brien v. United States*, 766 F.2d at 1049.

The Court of Appeals for the Seventh Circuit noted, however, that the single- transaction test had been met. The court stated:

> The "single transaction test," requiring that a "single transaction or taxable event ha[s] been subjected to two taxes on inconsistent theories," *Rothensies*, 329 U.S. at 300, 67 S. Ct. at 272, also appears to be satisfied on these facts if we adopt the reasoning of the Third Circuit in *Boyle*. The *Boyle* court ruled that the "single transaction test" was satisfied where undeclared dividends were erroneously treated as assets, included as part of the corpus of decedent's estate and subjected to estate tax, but later were ruled taxable income upon distribution to the beneficiaries. The net effect, the court noted, was inconsistent treatment of the same fund directly resulting in an overpayment of tax by the estate. Essentially the same situation exists

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cepted this argument, but the Court of Appeals for the Seventh Circuit reversed this conclusion. See *O'Brien v. United States*, 582 F. Supp. 203, 206-207 (C.D. Ill. 1984), revd. 766 F.2d 1038 (7th Cir. 1985).

here where inconsistent tax treatment of the same stock (in terms of valuation) has directly resulted in the overpayment of tax by the beneficiaries. [*O'Brien v. United States*, *supra* at 1050-1051 n.16]

Petitioner also relies upon *Estate of Vitt v. United States*, 706 F.2d 871 (8th Cir. 1983), to support its position that double taxation of the same fund under inconsistent theories satisfies the single-transaction requirement.[14] In *Estate of Vitt v. United States*, *supra*, Edward Vitt owned property with his wife, Verlena, which they held as tenants in the entirety even though Edward had provided all the consideration for its purchase. The Vitts conveyed the property by three separate deeds to their daughters and grandchildren, retaining a life estate for their joint lives. When Edward died in 1964, his estate included one-half of the value of the property for estate tax purposes. In reliance upon a revenue ruling that construed section 2036, the Government determined that the entire value of the property, less the actuarial value of Verlena's life estate, was includable in Edward's gross estate. This resulted in the inclusion of more than one-half of the value of the property in Edward's estate. The estate paid the tax and interest due, and later, the revenue ruling was revoked.

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[14] The Court of Appeals for the Eighth Circuit cited *Estate of Vitt v. United States*, 706 F.2d 871 (8th Cir. 1983), in a recently decided case, *Coohey v. United States*, 172 F.3d 1060, (8th Cir. 1999). In *Coohey v. United States*, *supra*, the court found that, under the facts of that case, an AMT refund, based upon repeal of a statute, for one year and the allowance of an AMT credit for the following year "are clearly a single transaction", because without the assessment and payment of the AMT for the earlier year, there would never have been an AMT credit given to the taxpayer for the succeeding year.

In 1975, Verlena died, and her estate tax return was filed reporting her interest in the property but assigning it no value for estate tax purposes. The estate did not report any value for Verlena's interest in the property because it was previously included in Edward's estate. The Government properly asserted that one-half of the value of the property was includable in Verlena's estate and determined a deficiency in the estate tax. The estate paid the deficiency and then filed suit for refund in District Court.

The District Court found that no more than one-half of the value of property was includable in Edward's estate and that the value in excess of that amount was included in error. See *Estate of Vitt v. United States*, 536 F. Supp. 403, 407 (E.D. Mo. 1982), affd. 706 F.2d 871 (8th Cir. 1983). Further, the District Court found that although the taxes were imposed at different times, the subject matter of the tax never changed. Therefore, "To hold on these facts that there is no common taxable event or fund would be to blindly follow a narrow, overly simplified definition of what constitutes a single transaction or taxable event". See *id.* at 408. Accordingly, the District Court found that Verlena's estate was entitled under the doctrine of equitable recoupment to a credit for the excess tax paid by Edward's estate.

In affirming, the Court of Appeals for the Eighth Circuit considered the Government's argument that the single-transaction requirement was not satisfied and found that, in addition to the double taxation of the same property, the inclusion of the property in both estates under section 2036 in essence resulted from the same transaction—the Vitt's transfer of the real property with retention of a life estate for their joint

lives and for the life of the survivor. See *Estate of Vitt v. United States*, 706 F.2d at 875.[15]

Finally, petitioner relies on *United States v. Herring*, 240 F .2d 225 (4th Cir. 1957), and *United States v. Bowcut*, 287 F.2d 654 (9th Cir. 1961). These cases, like the case now before us, concerned the estate tax and the income tax, and in both cases the taxes were not imposed on a single taxable event. In both cases, however, the single-transaction requirement was found to be satisfied, and equitable recoupment was applied in the taxpayer's favor.

In *United States v. Herring*, *supra*, the decedent died in 1948, and his surviving spouse, as administratrix, filed the estate tax return in 1949, paying the tax due. In 1951, the Government issued a preliminary notice proposing a deficiency in income taxes, civil penalties for fraud, delinquency penalties, and interest against the surviving spouse individually and the estate for the

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[15] Although arguably there were two taxable events in *Estate of Vitt v. United States*, *supra*,—the death of Edward Vitt and the death of Verlena Vitt, see *Parker v. United States*, 110 F.3d 678, 684 (9th Cir. 1997) (finding that death is a taxable event), see *infra* p. 46—the Court of Appeals for the Eighth Circuit considered the single transaction requirement met by the precipitating transaction, the lifetime transfer of the property to the Vitts' descendants. Similarly, in the instant case, arguably there were two transactions or taxable events—the transfer of the stock to petitioner upon decedent's death and the subsequent sale by petitioner of that stock—the precipitating transaction, however, was the valuation of the same item in the transfer from decedent to petitioner. We note that the Supreme Court in *Bull v. United States*, 295 U.S. 247 (1935), also did not consider the death of Bull and the transfer of the overvalued partnership interest to the estate; instead it viewed the precipitating transaction—the distribution of the partnership income—as the single transaction.

years 1932 to 1948. The assessment for tax was made in 1952, after the time for filing a claim for refund of the estate taxes had expired. The administratrix filed suit for refund of the estate taxes that would not have been due if the income tax deficiency had been deducted from the value of the estate, but the District Court dismissed this suit as untimely. The administratrix then paid the income tax deficiency, which greatly reduced the size of the estate, and sued for refund of the income taxes paid on the theory that the estate was entitled to equitable recoupment of the overpayment of the time-barred estate tax. The District Court approved this theory and gave judgment for the estate in the amount claimed, and the Government appealed.

In affirming, the Court of Appeals for the Fourth Circuit distinguished *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 396 (1946), on the ground that there the transactions "were too remote from one another to justify recoupment and that claims so long dead could not be resurrected under the doctrine." *United States v. Herring, supra* at 227. The Court of Appeals for the Fourth Circuit found that, although the case might differ in some respects from *Bull v. United States, supra*, in both cases

> the Government has received monies which in equity and good conscience belong to the taxpayer, and in both the allowance of recoupment should be made to avoid the bar of the statutes of limitations. It is true that in the Bull case both claims of the Government grew out of the same transaction and were asserted against the same money in the hands of the executor; but that, in practical effect, is the situation that prevails here. The Government has asserted two claims against the monies of the estate

> that came into the hands of the administratrix—one on account of past due income taxes and the other on account of the estate tax due on the net estate, and it is impossible to determine the amount of the latter without making due allowance for the deduction caused by the former. * * * [*United States v. Herring*, 240 F.2d at 228.]

Four years after the Court of Appeals for the Fourth Circuit decided the *Herring* case, the Court of Appeals for the Ninth Circuit affirmed a case with similar facts, *United States v. Bowcut*, 287 F.2d 654 (9th Cir. 1961), affg. 175 F. Supp. 218 (D. Mont. 1959). In this case, the decedent died in 1952, and the executrix (decedent's former wife) filed the estate tax return in 1953, paying the tax due. In 1954, the Government proposed adjustments to decedent's income tax for 1947 through 1950 for additional income tax, civil fraud penalties, and interest. The executrix paid the taxes, penalties, and interest in installments, and filed suit in District Court for refund of income tax in the amount of the overpaid estate taxes on the grounds of equitable recoupment.

In the District Court, the Government argued, inter alia, that equitable recoupment was not appropriate under *Bull v. United States, supra*, because the single-transaction requirement was not satisfied. The District Court, relying upon *United States v. Herring, supra*, dismissed that argument because the same money was involved in both the claim for the income tax deficiency and the claim for estate tax. See *Bowcut v. United States*, 175 F. Supp. at 222.

On affirming the District Court, the Court of Appeals for the Ninth Circuit did not consider the single-transaction issue, as the Government appealed primarily on other grounds, which the court rejected, for denying

equitable recoupment. See *United States v. Bowcut*, 287 F.2d at 656-657 & n.1 (9th Cir. 1961). Although the Court of Appeals did not consider whether the single-transaction requirement was satisfied, it did note that "In this case the taxpayer emphasizes that she is seeking to recover the overassessment of estate tax by recoupment from the very fund which, taken from the estate, had brought about the fact of overassessment." *Id.* at 656.

Years after *United States v. Herring*, *supra*, and *United States v. Bowcut*, *supra*, were decided, the Commissioner accepted the logic of these decisions and agreed in Rev. Rul. 71-56, 1971-1 C.B. 404, to apply equitable recoupment in these circumstances.[16] Despite the statement of administrative position in Rev. Rul. 71-56, *supra*, respondent now argues that the single-transaction requirement is not met in the case at hand. In support of his position, respondent cites two Court of Claims cases, *Wilmington Trust Co. v. United States*, 221 Ct. Cl. 686, 610 F.2d 703 (1979), and *Ford v. United States*, 149 Ct. Cl. 558, 276 F.2d 17 (1960).

In *Wilmington Trust Co. v. United States*, *supra*, the Government argued equitable recoupment in a factual context similar to *United States v. Herring*, *supra*, and *United States v. Bowcut*, *supra*.[17] In this consolidated case, individual taxpayers, Carpenter and McMullan, had been engaged in forest and land management. Carpenter and McMullan incurred certain expenses in

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[16] Rev. Rul. 71-56, 1971-1 C.B. 404, 470, revoked Rev. Rul. 55-226, 1955-1 C.B. 469, which ruled, citing *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296 (1946), that equitable recoupment was not available in these circumstances because the single-transaction requirement was not satisfied.

[17] See Andrews, *supra* at 641.

these activities which they properly deducted as ordinary and necessary business expenses. After Carpenter and McMullan had died, the Government determined deficiencies in their predeath income taxes, on the theory that the expenses were reductions in the amount of capital gain that Carpenter and McMullan each had realized on sales of timber. The executor of each decedent's estate paid the income tax deficiencies and deducted the income taxes paid as claims against the decedent's gross estate. Each estate was allowed these deductions for estate tax purposes.

Each estate also timely filed an administrative claim for refund of the predeath income taxes it had paid; the claims were denied, and each of the executors filed suit for refund of income tax in the Court of Claims. If allowed, the refunds of the improperly paid income taxes would have resulted in estate tax deficiencies, as the earlier deductions allowed for the income tax claims against the estates would have been overstated. After the period of limitations had expired for the Government to assert contingent claims against the estates, the Government amended its answer in the refund suits seeking under the doctrine of equitable recoupment to offset any resulting estate tax deficiencies against any income tax refunds the court determined to be due.

In both cases, the trial court judges, citing *Herring v. United States, supra, Bowcut v. United States, supra,* and Rev. Rul. 71-56, *supra,* found the single-transaction requirement had been satisfied, and recommended decision for the Government. See *Wilmington Trust Co. v. United States,* 43 AFTR 2d 79-801, 79-1 USTC par. 9223 (Ct. Cl. Trial Div. 1979), revd. and remanded 221 Ct. Cl. 686, 610 F.2d 703 (1979); *McMullan v. United*

States, 42 AFTR 2d 78- 5723, 78-2 USTC par. 9656 (Ct. Cl. Trial Div. 1978).

The Court of Claims reversed the trial court and held for the taxpayers, stating that it was obliged by *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296 (1946), to give the single-transaction requirement a narrow, inflexible interpretation. See *Wilmington Trust Co. v. United States*, 221 Ct. Cl. 686, 610 F.2d 703, 713 (1979). In finding that the single-transaction requirement was not satisfied, the court stated:

> The income tax refund is based upon the deductibility from ordinary income of the timber operations expense. The estate tax deficiency, however, exists because the estate deducted the additional income taxes reflecting those expenses that it paid and now is recovering. The recoupment claim thus arises from a different transaction (the reduced deduction from the estate tax) than the refund claims (the increased deductions from ordinary income). The government is not seeking to offset against each other two taxes levied on the same transaction, but to offset the tax on one transaction against the tax on another. * * * [*Id.* at 714.]

Thus, although the precipitating transaction was the deduction of the business expenses, the Court of Claims did not find this sufficient.[18]

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[18] Academic commentators have almost invariably supported the *Herring-Bowcut* analysis over the conclusion of the Court of Claims. See Andrews, *supra* at 630-650; Willis, "Some Limits of Equitable Recoupment, Tax Mitigation, and Res Judicata: Reflections Prompted by *Chertkof v. United States*", 38 Tax Law. 625, 642-645 (1985).

In 1939, the taxpayers (children) in *Ford v. United States*, 149 Ct. Cl. 558, 276 F.2d 17 (1960), received stock in a closely held Brazilian coffee company from their deceased father's estate. For estate tax purposes, the executors reported the date-of-death fair market value of the stock at $11,857, which was adjusted upward to $23,715 in an audit of the estate tax return. Eight years later, in 1947, the children sold the stock for $258,948, and reported gain based upon the adjusted date-of-death value of the stock. The children then filed a timely claim for refund, asserting that the basis reported on the income tax returns was erroneous, and that the correct date-of- death value, and, therefore correct basis, was $331,418. See *id.* at 20.

The Government denied the refunds, on the basis of the date-of-death value reported in the estate tax return. The children filed suit in the Court of Claims, and at trial the court found that the actual fair market value of the stock at the date of the father's death was greater than the amount the children received in the 1947 sale. The Government did not advert that it might be entitled under the doctrine of equitable recoupment to offset the overpaid income tax against the earlier underpaid estate tax. However, on its own initiative the Court of Claims considered this issue, and on a 3-2 vote, held that the Government was not entitled to recoupment because the facts were not identical to those in *Bull v. United States*, 295 U.S. 247 (1935), and *Stone v. White*, 301 U.S. 532 (1937). The court found that although "The instant case comes fairly close to satisfying the recoupment standards of the Supreme Court, * * * the teaching of *Rothensies* is that [the doctrine of equitable recoupment] is not a flexible doctrine, but a doctrine strictly limited, and limited for

good reason." *Ford v. United States*, 276 F.2d at 23. The Court of Claims did not cite *United States v. Herring*, *supra*, and *United States v. Bowcut*, 287 F.2d 654 (9th Cir. 1961), and Rev. Rul. 71- 56, *supra*, had not yet been issued.

The "good reason" referred to in *Ford v. United States*, *supra*, is the avoidance of the kind of staleness that the Supreme Court feared in *Rothensies v. Electric Storage Battery Co.*, *supra*.

That concern does not apply in the case at hand. An automatic feature arising from the statutory relationship between the estate tax and the income tax is that once the value of the item included in the gross estate is finally determined, there is little or no factual issue with respect to the time-barred claim; hence there is no genuine issue of staleness. Furthermore, as the value improperly excluded from (or included in) the gross estate automatically is the same amount erroneously included in (or excluded from) gross income, neither the Commissioner nor the taxpayer is required to perform extensive additional recordkeeping or investigation with respect to the time-barred claim. Finally, unlike the overpaid excise taxes in *Rothensies v. Electric Storage Battery Co.*, *supra*, which had been collected for more than 2 decades and time barred for more than 15 years, in this case the open claim and the time-barred claim arose at approximately the same time.

In two recent decisions, *Estate of Harrah v. United States*, 77 F.3d 1122 (9th Cir. 1995), and *Parker v. United States*, 110 F .3d 678 (9th Cir. 1997), the Court of Appeals for the Ninth Circuit, the circuit to which any appeal in this case would lie, held that equitable recoupment was not available because, inter alia, on the facts in those cases no tax had been imposed twice on a

single transaction. These cases are distinguishable from the case at hand.

In *Estate of Harrah v. United States, supra,* William F. Harrah died in 1978. His estate included 5,930,301 shares of common stock of Harrah's Inc. (Harrah's), which were valued at $13.325 per share in the estate tax return filed in 1980. In 1980, Harrah's was merged with Holiday Inns, Inc. (Holiday Inns). In this merger, the estate received $60,262,886 of cash, a $45 million promissory note executed by Holiday Inns, and convertible subordinated debentures of Holiday Inns with a face value of $105,262,800.

The amount of the taxable gain reported by the estate from the merger transaction depended upon the value of the promissory note and the convertible subordinated debentures and the basis of the Harrah's stock. On its 1980 income tax return, the estate valued the promissory note at its face value, $45 million, and the convertible subordinated debentures at $84,210,240, on the basis of a 20-percent discount from their face value. Accordingly, the estate reported $110,451,865 of taxable gain on its return.

In 1982, the estate converted the debentures into Holiday Inns stock, which resulted in a basis of $16 per share. In this year, the Government determined a deficiency in estate tax, contending that the value of the Harrah's stock was $34.05 rather than $13.325 as reported on the return.

In 1983, the estate sold 679,400 shares of Holiday Inns stock for $25,159,789, and distributed 1,101,447 shares to a marital trust that was established by William F. Harrah's will, which also provided that the marital trust was to be funded from the estate. In 1984,

the estate sold 58,200 shares of Holiday Inns stock for $2,620,487, and the marital trust sold all its shares for $58,177,080. In each of these sales, the $16 basis was used to compute the gain realized.

The estate filed a petition with this Court, contesting the Commissioner's determination of the value of the Harrah's stock that it reported on the estate tax return. In 1986, during the pendency of this litigation, the estate filed a timely income tax refund claim for 1980, on the ground that if it had undervalued the Harrah's stock, it had then overstated the gain it realized in the 1980 merger with Holiday Inns. At this time, the Commissioner and the estate stipulated that for estate tax purposes the Harrah's stock had a value of $19.41 per share. Because of this stipulation, the value of the Harrah's stock was not an issue on appeal. See *Estate of Harrah v. United States*, *supra* at 1125 n.4.

After the stipulation of the value of the Harrah's stock, the estate filed a revised claim for refund of its 1980 income taxes. In 1988, the Government stated that it would oppose the 1980 refund claim on the grounds that the convertible subordinated debentures were undervalued. In 1989, the estate filed suit in District Court for refund of $10,542,641 of income tax paid for the 1980 taxable year.

At this time, the estate filed a claim for refund of income taxes for the 1983 and 1984 taxable years, and the marital trust filed a claim with respect to its 1984 taxable year. The claims filed for 1983 and 1984 were denied on the grounds that they were untimely. As a result of the denial of these claims, the estate amended its refund suit in District Court to include its claims for the 1983 and 1984 years. The marital trust joined in

this action, and sought a refund for its 1984 taxable year.

The District Court applied the doctrine of equitable recoupment and found the three refund claims were not barred by the statute of limitations and also found that the proper discount was 16.8 percent from the face value of the convertible subordinated debentures, rather than 20 percent as reported on the estate's 1980 income tax return. The District Court's determination of the amount of the discount was accepted by the Government and was not an issue on appeal. See *Estate of Harrah v. United States, supra* at 1125.

The only issue before the Court of Appeals for the Ninth Circuit was whether equitable recoupment would provide jurisdiction for the court to consider the estate's and trust's 1983 and 1984 time-barred claims for refund of the income tax paid on their sales of the Holiday Inns stock. See *Estate of Harrah v. United States, supra.*

In deciding this issue, the Court of Appeals stated:

> The "single transaction" requirement is but a reflection of the requirement that recoupment by the taxpayer on a time-barred claim is available only when it is asserted defensively against a timely claim by the government with respect to the same transaction. A time-barred claim alone cannot provide jurisdiction to remove that bar. [*Id.* at 1126.]

The Court of Appeals found that both the estate and marital trust were seeking to employ equitable recoupment offensively as the basis of jurisdiction, in a manner not countenanced by *Bull v. United States, supra,* and *United States v. Dalm, supra.* See *id.* at 1126. Further, the Court of Appeals found that the

estate's and trust's attempts to supply the required jurisdiction by characterizing their efforts to reduce their 1983 and 1984 taxes as an assertion of equitable recoupment in respect to the open 1980 tax year must fail because consideration of the 1983 and 1984 years was barred by the statute of limitations, and the 1983 and 1984 sales of the Holiday Inns stock transactions were distinct from the Harrah/Holiday Inns merger transactions occurring in 1980. Although the Court of Appeals found "a common thread of factual similarity" linking the 1983 and 1984 transactions with the 1980 transactions, it was not enough to provide jurisdiction. See *id.* at 1126.

In *Estate of Harrah v. United States*, 77 F.3d 1122 (9th Cir.1997), the Court of Appeals for the Ninth Circuit did not decide the issue now before us; the value of the stock in *Harrah* had been stipulated, and when the District Court determined the value of the convertible debentures, it consequently determined the amount of gain from the sale of that stock. Unlike the stock at issue in this case, the convertible subordinated debentures were not items included in the estate for estate tax purposes. Furthermore, as the taxpayer's 1980 claim for refund of the overpayment of income tax realized in that sale was not time barred, the court did not have to consider the issue of whether the estate could recoup the excess income tax paid as a credit against the underpaid estate tax. In short, the issue now before us is the issue that was not before the Court of Appeals.

In addition to these differences, the instant case is otherwise distinguishable from *Estate of Harrah v. United States, supra.* In our case, petitioner is not seeking to gain jurisdiction with a time-barred claim;

we have jurisdiction because respondent determined a deficiency in petitioner's estate tax, issued a notice of deficiency, and petitioner filed timely a petition in response thereto. Moreover, petitioner is not attempting to reduce the income tax paid in the time-barred year; it is asserting that equitable recoupment is available to reduce the estate tax deficiency in the open year with the income tax on the same item that earlier was erroneously overpaid.

Most importantly, the 1983 and 1984 sales of the Holiday Inns shares by the estate and trust were many transactional generations removed from the transfer of the Harrah's stock to the estate and its sale of that stock in the merger. Neither the convertible subordinated debentures nor the Holiday Inns shares were items included in the estate. Furthermore, unlike the item in *Bull v. United States*, *supra*, and the item in the instant case, the Holiday Inns shares were not taxed once under the estate tax as corpus and again under the income tax as capital gain.

Finally, unlike the case at hand, where the only act of petitioner that contributed to the circumstance of double taxation was the erroneous valuation of those assets, see *United States v. Bowcut*, 287 F.2d at 656 (the "only act of this taxpayer [the executrix] which contributed to the circumstance of a double tax upon the estate was her erroneous return of estate tax liability"), the taxpayer in *Estate of Harrah v. United States*, *supra*, engaged in several sales transactions with multiple valuation errors.

In *Parker v. United States*, 110 F.3d 678 (9th Cir. 1997), the appellants (sisters) were the two daughters of Eleanor Parker (mother), who died in 1971. In 1972, the sisters sued Edward Allison (stepfather), alleging

that he had abused his role as a fiduciary by embezzling funds from the mother's separate assets and from a testamentary trust created by the mother in 1958 for the sisters. The suit was settled in 1975 with the stepfather agreeing in part to create a $325,000 settlement trust. The income of the settlement trust was to be paid to the stepfather, and the remainder was to be paid to the sisters upon his death.

The stepfather died in 1985. At the request of the executor of the stepfather's estate, and over the objections of the sisters, the trustee paid $90,000 in estate taxes owed by the stepfather's estate from the corpus of the settlement trust. The sisters filed a timely claim for refund following the estate tax payment, which was rejected by the Government. The sisters then filed suit for refund in the District Court.

In the District Court, the Government moved for summary judgment arguing that the sisters were not entitled to a refund because the value of the settlement trust, if not part of the stepfather's estate, was part of the mother's estate.[19] The Government claimed—by way of asserted equitable recoupment—that taxes due from the mother's estate greatly exceeded the $90,000 that the sisters were trying to recover. The District Court granted the Government's motion.

The sisters filed a timely motion for reconsideration in 1995, arguing for the first time that equitable

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[19] The District Court found that at the time of her death, the mother had a cause of action against the stepfather for his fraudulent conveyances. By converting the mother's asset (her cause of action) into a sum certain by settling the claim, that sum was therefore includable in the mother's gross estate. See *Parker v. United States*, 110 F.3d 678, 681 (9th Cir. 1997).

recoupment did not apply because the case did not involve a single transaction or an identity of interest as required under the doctrine. The District Court denied the sisters' motion for reconsideration, finding that equitable recoupment applied. The District Court reasoned that the case involved a single transaction, the taxation of the settlement trust, and that the requisite identity of interest was present because the parties seeking the refund were the same parties who received the benefit of a larger inheritance when the mother's estate was not taxed.

On appeal, the Court of Appeals for the Ninth Circuit accepted the Government's concession that the settlement trust had been improperly included in the stepfather's estate. However, the Court of Appeals concluded that even if the mother's claim against the stepfather had been includable in her estate, the Government's claim against her was time barred and that bar could not be circumvented by application of the doctrine of equitable recoupment because this case involved two or more taxpayers, two or more transactions, no inconsistent treatment between them, and no equitable reason to deny the sisters their refund.

In concluding that the District Court erroneously combined two or more separate transactions and analyzed them under the guise of taxation of the trust, the Court of Appeals for the Ninth Circuit observed that when the Supreme Court declared in *Rothensies v. Electric Storage Battery Co.*, 329 U.S. at 299, that equitable recoupment

> "permit[s] a transaction which is made the subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in

> view of the one transaction as a whole ." * * * This pronouncement, however, does not mean that courts should lump together related, but nonetheless separate transactions so that the facts of a case can be viewed as "one transaction as a whole." * * * [*Parker v. United States*, *supra* at 684; citation omitted.]

A number of factors contributed to the Court of Appeals' decision in *Parker* to treat the sisters' matter as involving more than a single transaction. First, neither the mother nor her estate was a party to the settlement trust created 4 years after the mother's death. Second, it was not the creation of the trust that gave rise to the tax liability that the Government claimed existed with respect to the mother's estate. The mother's estate tax liability existed because she possessed a valuable right when she died, the claim against the stepfather for conversion, embezzlement, and breach of fiduciary duty. The Court of Appeals for the Ninth Circuit reasoned that these "transactions" (the mother's death or the stepfather's tortious conduct giving rise to the mother's chose in action) were undeniably separate from the event giving rise to the sisters' refund claim—the stepfather's death and the concededly erroneous taxation of his estate. See *Parker v. United States*, *supra* at 684. While the Court of Appeals conceded that the creation and taxation of the settlement trust were in some ways related to these various transactions, it found that any factual and arithmetic link between them was insufficient to enable the Government to succeed in its claim for recoupment. See *id.*

In contrast to *Parker*, in which the mother was not even a party to the creation of the settlement trust, in

the case at hand, petitioner both undervalued and sold the shares of stock that gave rise to the estate tax deficiency, and the same undervaluation and sale automatically resulted in petitioner's realization of excess income, and the payment of excess income tax. Therefore, unlike the taxpayer in *Rothensies v. Electric Storage Battery Co.*, *supra*, and the Government in *Parker v. United States*, *supra*, petitioner is not attempting to lump distinct transactions separated by many years into a single taxable event.[20]

Any appeal in this case would lie to the Court of Appeals for the Ninth Circuit, and we are bound by any decision of that court squarely in point. See *Golsen v. Commissioner*, 54 T.C. at 756-757. However, the Court of Appeals did not consider the precise issue now before us, and both *Estate of Harrah v. United States*, 77 F.3d 1122 (9th Cir. 1995), and *Parker v. United States*, 110 F .3d 678 (9th Cir. 1997), are otherwise distinguishable on their facts; *Golsen* does not apply. See *id.*

Here, there is more than a mere logical relationship or factual and arithmetical link between the tax paid on the gain realized on the shares sold by petitioner and the valuation of those same shares for the estate tax. Because of the statutory relationship between sections

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[20] When the taxpayer in *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296 (1946), brought suit in 1943, the claim pleaded as recoupment was for taxes collected over 20 years before and barred by statute for over 16 years. See *id.* at 302-303. Similarly, in *Parker v. United States*, 110 F.3d 678 (9th Cir. 1997), the settlement trust was created in 1975, 4 years after the mother's death, and it was a decade later before the Government "roused to action" when the sisters sought the refund to which they were entitled. See *id.* at 685. In the instant case, the stock was sold by petitioner in the year immediately following decedent's death.

2031 and 1014, there is automatic causality between the fair market value of shares reported by the estate and the gain recognized on the sale of the same property. The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent that is equal to the value placed upon such property for purposes of the Federal estate tax. See sec. 1.1014-1(a), Income Tax Regs. Once the proper date-of-death fair market value is established by judicial process and made subject to the estate tax, it is automatic, under the facts of this case, that gain has been improperly subjected to the income tax. Accordingly, we find that the single transaction, item, or taxable event requirement is met.

3. *Inconsistent Treatment*

Both the estate and the income tax depend upon the same matter of fact—the fair market value of the shares at the date of decedent's death. Accordingly, the value existing at decedent's death is taxed only once. See secs. 1014, 2031.

With respect to this issue in *Parker v. United States*, *supra*, the Court of Appeals for the Ninth Circuit compared the facts of that case, in which there was an erroneous inclusion in the stepfather's estate and an erroneous failure to assess the full value of the mother's gross estate, with *Bull v. United States*, 295 U.S. 247 (1935), in which the same amount of partnership profits was taxed as both corpus and income. See *Parker v. United States*, *supra* at 685. In *Parker*, the court reasoned that while the Government's failure to determine a deficiency in the mother's estate on the basis of the value of the remainder interest, and the inclusion of the corpus in the stepfather's estate were both wrong, the erroneous tax treatment of the

separate estates was not the result of inconsistent theories of taxation as required under the doctrine. See *id.*

The instant case is clearly distinguishable from *Parker v. United States, supra.* In this case, the same item has been subjected to taxation under inconsistent theories, as corpus under the estate tax and as capital gain under the income tax. We conclude that this requirement is satisfied. See *Bull v. United States, supra* at 261; see also *Boyle v. United States,* 355 F.2d at 236 (treatment of the same fund as both corpus and income provided the necessary inconsistency of treatment).

4. *Identity of Interest*

The courts that have found equitable recoupment available in the cases before them have not required absolute identity of interest between the payor of the erroneous overpayment (or underpayment where the Government asserts recoupment) and the recipient of the recoupment. However, if the subject transaction involves two or more taxpayers, equitable recoupment will not be available unless a sufficient identity of interest exists so that the taxpayers should be treated as one. See *Parker v. United States, supra* at 683.

In the instant case, we find that there is sufficient identity of interest between petitioner and the payor of the tax that petitioner seeks to recoup. Decedent's will provides that the estate taxes are to be paid from the residue of the estate, and petitioner sold stock included in that residue to pay its estate tax liability. The gain realized on the sales passed through to the residuary legatee, March, who reported the gain and paid the income tax due. Any adjustment through recoupment

will benefit only the residuary legatee, and any distinction of legal entities would be purely artificial. See *Stone v. White*, 301 U.S. 532 (1937) (identity of interest between the trust which paid the tax and the beneficiary who had received the income); *Estate of Vitt v. United States*, 706 F.2d 871, 875 n.3 (8th Cir. 1983) (sufficient identity of interest between the separate estates of deceased spouses, because the same parties detrimentally affected by the overpayment of estate tax would receive the proceeds from recoupment); *Boyle v. United States*, *supra* at 236 (sufficient identity of interest between estate that paid estate tax on accumulated dividend arrearages included in corpus and all the beneficiaries of the estate who later were paid the dividends and liable for the income tax thereon); *United States v. Herring*, 240 F.2d 225, 228 (4th Cir. 1957) (sufficient identity between decedent and estate); *Bowcut v. United States*, 175 F. Supp. 218, 221-222 (D. Mont. 1959) (same).

To reflect the foregoing,

Decision will be entered under Rule 155.

Reviewed by the Court.

GERBER, WELLS, COLVIN, HALPERN, BEGHE, CHIECHI, LARO, FOLEY, VASQUEZ, GALE, THORNTON, and MARVEL, JJ., agree with this majority opinion.

BEGHE, J., concurring.

BEGHE, J.

Having joined the majority opinion, I write separately to respond to Judge Chabot's argument that the structure of our deficiency jurisdiction prohibits us from applying equitable recoupment to redetermine petitioner's estate tax deficiency.

In Judge Chabot's view, the sole issue for decision in the case at hand, as he argued in *Estate of Mueller v. Commissioner*, 101 T.C. 551, 565- 566 (1993) (Mueller II), is the valuation of the Savings and Willits shares included in decedent's gross estate. Inasmuch as we have performed that task in Branson I, the dissent contends that nothing remains for us to do to redetermine petitioner's estate tax deficiency. I disagree: Our valuations also, as a practical matter, have redetermined a corresponding increase in the section 1014(a) basis of the shares, resulting in the residuary legatee's time-barred overpayment of tax on the sale of the shares.

Working with the definition of "deficiency" in section 6211(a), there is a way in which the residuary legatee's overpayment is taken into account in computing petitioner's estate tax deficiency. While the approach I suggest requires an element of fictive or "as if" thinking in applying the statute, I believe the grounds for applying equitable recoupment to the facts of this case support an interpretation of section 6211(a) that allows the residuary legatee's overpayment to be taken into

account in determining petitioner's estate tax deficiency.

As Judge Chabot points out, the Tax Court's task in this case is to redetermine petitioner's estate tax deficiency, and "deficiency" is a term of art in Federal taxation that has special significance for our jurisdiction. See *Murphree v. Commissioner*, 87 T.C. 1309, 1311 (1986); *Martz v. Commissioner*, 77 T.C. 749, 754 (1981); *Hannan v. Commissioner*, 52 T.C. 787, 791 (1969). Section 6211(a) defines "deficiency" as follows:

38 SEC. 6211 DEFINITION OF A DEFICIENCY.

(a) In General.—For purposes of this title in the case of income, estate, and gift taxes imposed by subtitles A and B and excise taxes imposed by chapters 41, 42, 43, and 44 the term "deficiency" means the amount by which the tax imposed by subtitle A or B, or chapter 41, 42, 43, or 44 exceeds the excess of—

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) the amount of rebates, as defined in subsection (b)(2), made.

In other words, the deficiency (d) equals the correct tax imposed (t) less the total tax shown on the return

(s) plus prior assessments (a) less rebates (r).[1] Under this definition, a deficiency in estate tax will generally result if a taxpayer is found to have undervalued property included in the gross estate because an increase in the value of included property will increase the amount of tax imposed by subtitle B. Just as the amount of the deficiency is affected by the amount of tax imposed under subtitle B, it can also be affected by "amounts previously assessed (or collected without assessment) as a deficiency", sec. 6211(a)(1)(B), see sec. 1.6211-1(e), Income Tax Regs., and rebates made, see sec. 6211(a)(2).

In applying equitable recoupment within the statutory scheme of section 6211(a), we are in effect holding, after concluding that the residuary legatee paid too much income tax on petitioner's gain on the 1992 sales of Willits and Savings shares, that petitioner has been assessed an additional amount of estate tax within the meaning of section 6211(a)(1)(B). In so doing, we treat the income tax overpayment as if it were a partial assessment of the estate tax deficiency. The residuary legatee's income tax overpayment thereby has the effect of reducing the amount of the estate tax deficiency, not as a below-the- line subtraction from the deficiency, but as an above-the-line (negative) element of the deficiency itself. See sec. 6211(a)(1)(B).

There is a long and honorable tradition of using legal fictions to overcome the rigidity of the law in order to

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[1] Expressed as a mathematical formula:

$d = t—(s + a—r)$.

The formula can also be expressed as follows:

$d = (t—s)—(a—r)$.

make the legal system function fairly.[2] A legal fiction is a falsehood that is deemed to be true for limited purposes designed to bridge the gap between concept and reality.[3] "A doctrine which is plainly fictitious must seek its justification in considerations of social and economic policy; a doctrine which is nonfictitious often has spurious self-evidence about it." L. Fuller, Legal Fictions 71 (1967).[4]

Miller, "Liars Should Have Good Memories: Legal Fictions and the Tax Code", 64 U. Colo. L. Rev. 1, 26 n.109 (1993).

The concepts of tax "deficiency" and "underpayment" are themselves legal constructs that amount to fictions, inasmuch as neither of them purports to be the amount of a petitioner's remaining obligation to pay tax; they stand in somewhat the same relationship to such obligation as shadows do to the three-dimensional object.

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[2] See *ACLU of Mississippi, Inc. v. Finch*, 638 F.2d 1336, 1340 n.7 (5th Cir. 1981), and texts cited. This case and these texts conclude that legal fictions can be useful and justified if employed with the understanding of producer and consumer of their character as such. See also *United States v. Dalm*, 494 U.S. 596, 612-623 (1990) (Stevens, J., dissenting), discussed *infra* pp. 7-8.

[3] In effect, when we engage in a fiction, we redefine reality to comport with existing law as a method of changing the law to meet new realities * * *. This method of adapting the law to changing circumstances and parceptions is saved from absurdity by its underlying rationality. * * * when used properly the legal fiction is a rule of law embodying an unconcealed falsehood at one level and a deeper truth at another more important level. The falsehood is often made necessary because of the pre-existing structure of the law, and is justified (if it is justified) by the deeper underlying truth contained within the falsehood.

[4] Originally published in slightly different form in three parts in 25 Ill. L. Rev. 363, 513, 865 (1930-31).

However, once a deficiency determined by the Commissioner (or redetermined by the Tax Court) is assessed, the deficiency becomes a legal obligation that the Commissioner can collect, and reality painfully intrudes.

By allowing the residuary legatee's overpayment to be taken into account in determining petitioner's estate tax deficiency, we do no more than give effect to the accepted notions that "the rule of equitable recoupment permits recovery of an otherwise barred claim by resort to the fiction that the overpayment is a credit or defense against a later asserted tax liability for a year open to suit" and that "The doctrine of equitable recoupment utilizes the fiction of a tax credit or defense to liability for a year open to suit to avoid violation of the statutory scheme providing for finality of tax determinations." *Holzer v. United States*, 250 F. Supp. 875, 877-878 (E.D. Wis. 1966), affd. per curiam 367 F.2d 822 (7th Cir. 1966).

"[T]he Supreme Court has explicitly and repeatedly stated that it is sometimes appropriate to interpret statutes in a manner inconsistent with their literal language." Zelenak, "Thinking About Nonliteral Interpretations of the Internal Revenue Code", 64 N.C. L. Rev. 623, 631 (1986). Zelenak notes, *id.* at 624, that in the preceding 4 years the Supreme Court had decided at least four tax cases by adopting on confirming a nonliteral interpretation of the Code.[5]

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[5] Citing and discussing *Paulsen v. Commissioner*, 469 U.S. 131 (1985); *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983); *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Hillsboro Natl. Bank v. Commissioner*, 460 U.S. 370 (1983).

Similarly, the "two wrongs make a right" character of equitable recoupment, see Willis, "Some Limits of Equitable Recoupment, Tax Mitigation, and Res Judicata: Reflections Prompted by *Chertkof v. United States*," 38 Tax Law. 625 (1985), emphasizes that "Recoupment, rather than extending the statute of limitations to correct a perceived injustice, permits a wronged party to recoup the loss against a sum still open to litigation." *Id.* at 633. In so doing, recoupment uses the legal fiction that the recoupment claim is an element in the computation of the tax subject to the timely claim, rather than the time-barred tax. The "two wrongs make a right" notion signifies that where an earlier matter has received erroneous tax treatment, "[recoupment] does not correct the wrong, as does the mitigation statute, but instead causes a later matter to be equally wrong in the opposite direction." *Id.*

As Justice Stevens observed in his dissent in *United States v. Dalm*, 494 U.S. 596, 612-623 (1990), the Supreme Court in *Bull v. United States*, 295 U.S. 247 (1935), could have taken the strict view that the statute of limitations barred the taxpayer's claim, but instead "avoided that unjust result" by construing the plaintiff's rights in a Federal tax refund suit by reference to those of a defendant, thereby proceeding "under * * * the presumption that for every right there should be a remedy." *United States v. Dalm, supra* at 616-617. Acknowledging that treating a plaintiff like a defendant "so as to permit, in effect, the equitable tolling of the limitations period" was perhaps "an unusually flexible treatment of legal categories," Justice Stevens observed that such treatment was "nothing more than the necessary expression of an exception to a generally appropriate definition", an exception that had received

the status of a legal rule under *Bull. Id.* at 618. See Tierney, "Equitable Recoupment Revisited: The Scope of the Doctrine Revisited in Federal Tax Cases after *United States v. Dalm*," 80 Ky. L.J. 95, 131-165 (1992).

In Mueller II, we opined that we have authority to apply equitable recoupment in a case over which we have jurisdiction; in *Estate of Mueller v. Commissioner*, 107 T.C. 203 (1996) (Mueller III), we held, consistent with the view of the majority in *United States v. Dalm, supra*, that equitable recoupment is properly confined to its traditional role as an affirmative defense.[6] Having held in the case at hand that the requirements of equitable recoupment have been satisfied, our application of the doctrine does no more violence to the structure of section 6211(a) than the availability of equitable recoupment in the refund forums does to the Internal Revenue Code as a whole.

LARO, J., concurring.

LARO, J.

The United States Tax Court is a court of law that, like the United States District Courts, has the authority to apply equitable principles such as equitable recoupment. The majority holds as much, and I agree. I write separately to emphasize the fact that this Court, although different from District Courts in a few regards, the most obvious of which is that District Courts were created under Article III of the U.S. Constitution whereas this Court was created under Article I of the U.S. Constitution, is a court of law that has the

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[6] This observation serves to distinguish equitable recoupment and the case at hand from *Commissioner v. Lundy*, 516 U.S. 235 (1996).

authority to apply all of the judicial powers of a District Court.

This Court's predecessors, namely, the Board of Tax Appeals and the Tax Court of the United States, were not courts of law, and they did not possess the judicial powers of a District Court. This Court's predecessors were independent agencies in the executive branch of the Federal Government, and, as such, their powers were limited to those powers conferred upon them by the executive branch. See *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 725 (1929). The fact that this Court's predecessors were executive agencies and not courts of law made them fundamentally different from the District Courts. The fact that this Court's predecessors were executive agencies and not courts of law made them fundamentally different from this Court.

Following the passage of the Tax Reform Act of 1969 (1969 Act), Pub. L. 91-172, sec. 951, 83 Stat. 730, the United States Tax Court is the functional equivalent of a District Court. See sec. 951 of the 1969 Act, 83 Stat. 730. See also *Freytag v. Commissioner*, 501 U.S. 868, 890-891 (1991). Through the 1969 Act, Congress changed the status of this Court from an "independent agency in the Executive Branch of the Government" to a "court of record" "established * * * under Article I of the Constitution of the United States". See sec. 7441 before and after amendment by the 1969 Act; see also *Freytag v. Commissioner*, *supra* at 890-891. Congress established the United States Tax Court through a constitutionally permissible exercise of its Article I powers. See *Freytag v. Commissioner*, *supra*. The United States Tax Court, as established by Congress

under the 1969 Act, sits as a district courtlike tribunal that "exercises a portion of the judicial power of the United States * * *. * * * to the exclusion of any other function". *Id.* at 891. This Court's judicial power allows the Court to decide cases without undue influence from either the executive or legislative branch. See *id.* at 890-891; *Roberts v.. Commissioner*, 175 F.3d 889 (11th Cir. 1999); see also *Burna, Stix Friedman & Co. v. Commissioner*, 57 T.C. 392, 395 (1971), wherein the Court stated:

> It is clear from the statutory language and the Senate committee report (S. Rept. No. 91-552, 91st Cong., 1st Sess., p. 302, 1969-3 C .B. 614) that Congress removed the Tax Court from the Executive Branch and established it as an article I court primarily for the purpose of recognizing its status as a judicial body and disposing of any problems that its status as an executive agency sitting in judgment on another executive agency might pose.

This Court's District Court like status means that the Court's decisions are subject to review only by a Federal appellate court. See sec. 7482(a) ("The United States Courts of Appeals * * * shall have exclusive jurisdiction to review the decisions of the Tax Court * * * in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury").

Appellate courts have repeatedly applied the law that preceded the 1969 Act to hold that the predecessors of the United States Tax Court were not courts of law and, more importantly, that these predecessors lacked judicial powers. In *Lasky v. Commissioner*, 235 F.2d 97 (9th Cir.1956), affd. per curiam 352 U.S. 1027

(1957), for example, the Court of Appeals for the Ninth Circuit held that the Tax Court of the United States, unlike a District Court, was without authority to vacate a final decision. The Ninth Circuit reasoned that the Tax Court of the United States was "not a court at all but merely an administrative agency". *Id.* at 98; accord *Swall v. Commissioner*, 122 F.2d 324 (1st Cir. 1941); *Sweet v. Commissioner*, 120 F.2d 77 (1st Cir. 1941). Other appellate courts had ruled similarly, applying the same reasoning. See, e.g., *White's Will v. Commissioner*, 142 F.2d 746 (3d Cir. 1944), affg. 40 B.T.A. 664 (1939); *Monjar v. Commissioner*, 140 F.2d 263 (2d Cir. 1944), affg. an unreported Order of the Board of Tax Appeals; *Denholm & McKay Co. v. Commissioner*, 132 F.2d 243 (1st Cir. 1942), vacating 41 B.T.A. 986 (1940) and reinstating 39 B.T.A. 767 (1939); see also *Helvering v. Northern Coal Co.*, 293 U.S. 191 (1934).

These prior cases do not address the current status of this Court as a court of law that performs exclusively judicial functions. None of these cases, therefore, has any bearing on the types of powers that this Court is authorized to exercise in performing our judicial functions. The Supreme Court acknowledged so much in *Freytag* when the Court held that Congress constitutionally established the United States Tax Court as a court of law that "[exercises] judicial power and perform[s] exclusively judicial functions" and, in so holding, rejected the Commissioner's argument that the 1969 Act "simply changed the status of the Tax Court within * * * [the executive] branch." *Freytag v. Commissioner*, *supra* at 885, 892. It naturally follows from Congress' elevation of this Court to an "exclusively judicial" court that this Court possesses all of the inherent powers of the judiciary and that this Court's

legal and equitable powers are diametrically different from this Court's executive agency predecessors which wielded executive powers only.

The Supreme Court has recently stated in dictum that the United States Tax Court lacks "general equitable powers". See *Commissioner v. McCoy*, 484 U.S. 3, 7 (1987) (per curiam). When taken in context, this statement is not remarkable. Nor is it inconsistent with the view of this Court as to our ability to exercise District Court like equitable powers. The context of the Supreme Court's statement in *McCoy* indicates clearly that the Court was merely applying the well-settled rule that no court of law may ignore the express intent of Congress as to the imposition of interest and penalties. See *id.*; see also *Flight Attendants Against UAL Offset v. Commissioner*, 165 F.3d 572, 578 (7th Cir. 1999) ("In context, the Supreme Court's dictum in *Commissioner v. McCoy*, 484 U.S. 3, 7, 98 L. Ed. 2d 2, 108 S. Ct. 217 (1987) (per curiam), that the Tax Court lacks 'general equitable powers' means only that the Tax Court is not empowered to override statutory limits on its power by forgiving interest and penalties that Congress has imposed for nonpayment of taxes—but then no court is, unless the imposition would be unconstitutional."). In fact, the Court made no mention of *McCoy* when it decided *Frevtag* 4 years later.

In sum, Congress, through the 1969 Act, elevated the status of this Court to a court of law, and the Supreme Court in *Frevtag* held that Congress' action was constitutional. As a Federal court of law, this Court naturally possesses the inherent powers of any other Federal court of law, e.g., the Federal District Courts, including the power to apply equitable principles such

as equitable recoupment. Because the Court holds as much today, I concur in our decision.

PARR, FOLEY, VASQUEZ, THORNTON, and MARVEL, JJ., agree with this concurring opinion.

CHABOT, J., dissenting.

CHABOT, J.

The majority hold that this Court has authority to apply the doctrine of equitable recoupment and "that petitioner is entitled to recoup the residuary legatee's excessive payment of income tax against the estate tax deficiency." *Supra* majority op. pp. 2-3. For the reasons set forth in my dissent in *Estate of Mueller v. Commissioner*, 101 T.C. 551, 565-571 (1993) (Mueller II), I respectfully dissent.

The majority opinion and Judge Laro's concurring opinion do not attempt to deal with the substance of that dissent; instead, they focus on this Court's status as a Court, as a result of the amendments made by the Tax Reform Act of 1969 (TRA '69), Pub. L. 91-172, sec. 951, 83 Stat. 730. I am well aware of the text of TRA '69, its legislative history, and the Congress' intentions. I am satisfied that there is nothing in the materials considered by or generated by the Congress in connection with TRA '69 that speaks to the issue of equitable recoupment; however, it is clear that the Congress did not intend to make this Court an "Article III court".

Firstly, clearly, this Court is a court.

Secondly, this Court is not a Federal District Court. This Court is a Federal trial court, like the District Courts, and must abide by the same Federal Rules of Evidence. However this Court has statutory authority

to prescribe its own Rules of Practice and Procedure (sec. 7453), which in many respects are different from the Federal Rules of Civil Procedure. This Court has statutorily prescribed deficiency jurisdiction, which the District Courts do not have; the District Courts have refund jurisdiction, which this Court does not have (except where an overpayment is developed in a case that began as a deficiency case, or in a "TEFRA partnership" or S corporation case). This Court has developed the "*Lawrence* doctrine", modified by the "*Golsen* doctrine", as described in *Lardas v. Commissioner*, 99 T.C. 490, 493-495 (1992), which does not have a practical counterpart in the District Courts. This Court's burden of proof rules in deficiency cases differ in some respects from those applicable in refund cases in the District Courts. See in this connection *Helvering v. Taylor*, 293 U.S. 507, 514 (1935). As to other differences between this Court and the District Courts, see *Commissioner v. Lundy*, 516 U.S. 235, 244-245, 252 (1996).

Thirdly, as to the critical dispute in the instant case, this Court and the District Courts differ in their statutory powers in such a way that equitable recoupment fits what the District Courts do (decide directly how much, including interest, the Government must pay to the taxpayer, or vice versa) and does not fit what this Court does, redetermine the amount of the deficiency, if any, which is merely one factor in how much must be paid.

Fourthly, nothing in the concepts of a "court", or a "court of law", makes equitable recoupment an essential characteristic of a court, or of a court of law.

My position remains that we are to resolve those matters which affect the amount of the estate tax deficiency to be set forth on the decision document we enter in the instant case. Equitable recoupment does not affect any of the elements of the deficiency, as statutorily defined, and so does not affect the decision we enter. Judge Beghe's concurring opinion does deal with this Court's deficiency jurisdiction, which is the only jurisdiction that brings the instant case before us. Judge Beghe's concurring opinion suggests a route by which the square peg of recoupment could he squeezed into the round hole of the statutory definition of deficiency.[1]

However, several aspects of this suggested route remain to be paved. *Firstly*, "deficiency" and "underpayment" are defined terms. Secs. 6211, 6664(a They are not legal fictions. The amount, if any, that a taxpayer may have to pay to the Government may well be different from the amount of the deficiency or any underpayment.

Secondly, the Supreme Court has recently indicated that, as to the Tax Court, the statute of limitations (the major impediment that equitable recoupment is designed to circumvent) must be given a strict application, and the equities are unavailing. See *Commissioner v. Lundy*, 516 U.S. 235 (1996). Thus, this Court was barred from holding that Lundy overpaid his income taxes even if his claim for refund would have been timely in a District Court. See *id.* at 251- 253 (majority op.), 253-254, 263 (Thomas, J., dissenting).

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[1] This imagery is generally thought to have originated in Sidney Smith's reference to "a square person has squeezed himself into the round hold." Sketches of Moral Philosophy (1850).

Also, Lundy lost even though it was clear that Lundy and his wife had substantially overpaid their income taxes. See *id*. at 237. *Lundy* did not involve the staleness, missing documents, and faded memories that statutes of limitations are generally established to guard against. The majority of the Supreme Court determined that there was no room for legal fictions suggested by Justices Thomas and Stevens, the Court of Appeals for the Fourth Circuit, or Lundy's counsel, to correct this obvious injustice, and the Government was permitted to hold onto the Lundys' overpaid taxes solely because of the text of the then-applicable statute of limitations. Of course, Lundy's situation does not fit into the current mold of equitable recoupment. The relevance of *Lundy* to our discussion is the Supreme Court's focus on the details of statutory grants and limitations of power and jurisdiction, and that Court's reluctance to modify the strictness of the statute even to correct an obvious injustice.

Thirdly, Judge Beghe's concurrence relies on the analysis of equitable recoupment in Justice Stevens' dissent in *United States v. Dalm*, 494 U.S. 596, 612-623 (1990). Although much understanding may be gleaned from a distinguished jurist's dissent, the fact remains that the dissent is what the Supreme Court's majority rejected.

COHEN and WHALEN, JJ. agree with this dissent.

APPENDIX D

UNITED STATES TAX COURT

Docket No. 10028-95

ESTATE OF FRANK BRANSON, DECEASED; MARY M. MARCH, EXECUTOR, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Entered: Dec. 15, 1999]

DECISION

Pursuant to the Opinions of the Court filed July 13, 1999, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED. That there is a deficiency in estate tax due from the petitioner in the amount of $348,016.00, and

That the petitioner is entitled, under the doctrine of equitable recoupment, to a credit of $96,515.00 for income tax overpaid by Mary M. March and Charles March for the taxable year 1992.

The parties stipulate that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of

either party to contest the correctness of the decision entered herein.

It is further stipulated that the deficiency takes into account the maximum allowable credit for State estate, inheritance, legacy or succession tax and petitioner shall not claim a credit for additional State estate, inheritance, legacy or succession tax.

It is further stipulated that, for the purpose of calculating petitioner's deficiency in payment and related interest, the income tax overpayment by Mary and Charles March shall be treated as a payment of estate tax as of April 15, 1993.

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Date: Dec. 7, 1999